

# EARLY, LENNON, CROCKER & BARTOSIEWICZ, P.L.C.

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DAVID G. CROCKER	RON W. KIMBREL
MICHAEL D. O'CONNOR	PATRICK D. CROCKER
HAROLD E. FISCHER, JR.	ANDREW J. VORBRICH
LAWRENCE M. BRENTON	TYREN R. CUDNEY
GORDON C. MILLER	STEVEN M. BROWN
GARY P. BARTOSIEWICZ	KRISTEN L. GETTING
BLAKE D. CROCKER	

PAID T.R.A.	
Chk #	<u>4726</u>
Amount	<u>25.00</u>
Rcvd By	<u>JP</u>
Date	<u>10-14-02</u>

RECEIVED  
02 OCT 14 PM 3 17  
OF COUNSEL  
THOMPSON BENNETT  
JOHN T. PETERS, JR.

VINCENT T. EARLY  
(1922 - 2001)  
JOSEPH J. BURGIE  
(1926 - 1992)  
TN REG. AUTHORITY  
SECRET ROOM

October 11, 2002

Joe Werner, Chief  
Telecommunications Division  
Tennessee Regulatory Authority  
460 James Robertson Parkway  
Nashville, TN 37243-0505

DOCKET NO.

02-01156

RE: Petition for Authority to Transfer Control of Startec Global Communications Corporation to Allied Capital Corporation

Dear Mr. Werner:

Enclosed herewith for filing with the Commission, please find an original and thirteen (13) copies of the petition to transfer control of Startec Global Communications Corporation, its wholly owned subsidiaries Startec Global Operating Corporation and Startec Global Licensing Corporation, to Allied Capital Corporation, along with a check in the amount of \$25.00 to cover filing fees for same.

Also enclosed is a duplicate of this letter. Please stamp the duplicate received and return same in the postage-paid envelope attached thereto.

Should you have any questions or concerns relating to this matter, please contact the undersigned.

Respectfully submitted,

EARLY, LENNON, CROCKER & BARTOSIEWICZ, P.L.C.

*Patrick D Crocker (Bmr)*  
Patrick D. Crocker

PDC/bmr

enc

**BEFORE THE TENNESSEE REGULATORY AUTHORITY**

Petition for Authority to Transfer Ownership or )  
Control of Startec Global Communications ) Docket No.  
Corporation to Allied Capital Corporation )

To the TRA:

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PETITION FOR AUTHORITY TO TRANSFER CONTROL

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STARTEC GLOBAL COMMUNICATIONS CORPORATION ("Startec"), its wholly owned subsidiaries Startec Global Operating Company ("Startec Operating"), and Startec Global Licensing Company ("Startec Licensing") and Allied Capital Corporation ("Allied") (collectively, the "Applicants"), by their attorneys, hereby respectfully request that the Tennessee Regulatory Authority ("TRA"), approve the transfer of control of Startec from its current shareholders to Allied. Since Startec, Startec Operating, and Startec Licensing will continue to provide such service in Tennessee, the Applicants do not seek to transfer Startec's operating authority in connection with this transaction. The Applicants request expedited treatment of this application in order to permit them to consummate the transaction without undue delay. In support hereof the parties would show unto the TRA the following to-wit:

**THE PARTIES**

1. Startec is a Delaware corporation. Through its subsidiaries Startec Operating and Startec Licensing, Startec provides domestic and international long distance services, striving, in particular, to meet the needs of select ethnic businesses and residential communities located in major metropolitan areas. The TRA authorized Startec Licensing as a long distance reseller in the State of Tennessee.

The principal address for Startec, Startec Operating and Startec Licensing will be:

1151 Seven Locks Road  
Potomac, MD 20854

2. Allied is a publicly owned Maryland corporation headquartered in Washington, D.C. Allied provides investment capital (in the form of both debt and equity securities) to private and undervalued public companies. Allied is currently the largest business development company in the United States. A copy of Allied's Articles of Incorporation is attached hereto as **Exhibit A**. The principal office of Allied is located at:

1919 Pennsylvania Avenue, NW  
Washington, DC 20006

3. Questions about this application should be directed to:

Patrick D. Crocker  
Early, Lennon, Crocker & Bartosiewicz, P.L.C.  
900 Comerica Building  
Kalamazoo, MI 49007  
Telephone: (269) 381-8844  
Facsimile: (269) 381-8822

#### **TRANSFER OF CONTROL**

4. On December 14, 2001, Startec and its wholly owned subsidiaries Startec Operating and Startec Licensing filed for bankruptcy under Chapter 11 of Title 11 of the U.S. Code in the U.S. Bankruptcy Court for the District of Maryland (Greenbelt Division)<sup>1</sup>.

#### **QUALIFICATIONS OF TRANSFEREE**

5. Allied is financially qualified to acquire control of Startec, Startec Operating, Startec Licensing and their business. A copy of Allied's financials is attached hereto as **Exhibit B**.

6. After the transaction, Startec, Startec Operating, and Startec Licensing will continue to operate as they have in the past. Startec, Startec Operating, and Startec Licensing will retain all key personnel, including certain senior management personnel.

7. Under the terms of a Debtors' Joint Plan of Reorganization ("Plan") filed with the Bankruptcy Court on June 14, 2002, Startec, Startec Operating, and Startec Licensing will be reorganized and reincorporated as new Delaware corporations, with the reorganized Startec

Operating and Startec Licensing continuing to be wholly-owned subsidiaries of Startec. Among the three reorganized debtors, Startec Licensing will provide all intrastate and interstate domestic services and will hold the licenses and authorizations required for those services. A copy of the Plan is attached hereto as **Exhibit C**.

8. Thus, the transfer of ownership or control will be transparent to, and have no adverse impact upon, Startec customers.

#### **PUBLIC INTEREST**

9. The transfer of control of Startec from its current shareholder to Allied is in the public interest as it will provide Startec, Startec Operating and Startec Licensing with the best opportunity to continue providing domestic services to customers in the State of Tennessee. Serving select ethnic and linguistic communities, in particular, Startec and its subsidiaries play a vital role in an important niche market.

10. In addition, Startec will have access to the financial resources it needs to introduce new products and services and to respond to competition in the competitive telecommunications environment in Tennessee. Over time, consumers in Tennessee will benefit from a greater number of products and service options as well as lower prices offered by Startec.

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<sup>1</sup> *In re Startec Global Communications Corp., et al.*, Case No. 001-25013 (DK).



**WHEREFORE**, Startec and Allied respectfully request that the TRA authorize the transfer of control of Startec from its current shareholder to Allied so that the transaction may proceed without undue delay.

Respectfully submitted,

Early, Lennon, Crocker & Bartosiewicz, P.L.C.

By: 

Patrick D. Crocker  
Early, Lennon, Crocker & Bartosiewicz, P.L.C.  
Attorneys for Startec Global Communications  
Corporation and Allied Capital Corporation

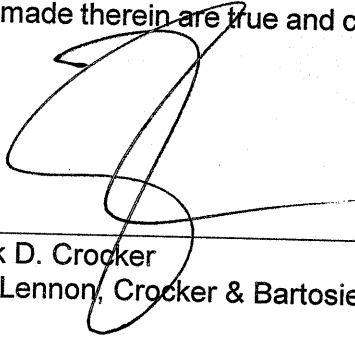
STATE OF MICHIGAN

COUNTY OF KALAMAZOO

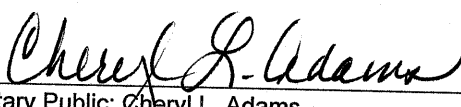
)  
) ss  
)

VERIFICATION

I, Patrick D. Crocker, Attorney for Startec Global Communications Corporation and Allied Capital Corporation, first being duly sworn on oath, deposes and says that he has read the foregoing Petition and certifies that the statements made therein are true and correct to the best of his knowledge, information and belief.

  
\_\_\_\_\_  
Patrick D. Crocker  
Early, Lennon, Crocker & Bartosiewicz, P.L.C.

The foregoing instrument was acknowledged before me this 4<sup>th</sup> day of October 2002 by Patrick D. Crocker.

  
\_\_\_\_\_  
Notary Public: Cheryl L. Adams  
Commission Expires: 06/24/05  
County of Kalamazoo, Michigan

**EXHIBIT A**

**Allied Capital Corporation:  
Articles of Incorporation**

8

ARTICLES OF RESTATEMENT  
OF  
ALLIED CAPITAL CORPORATION

To the State Department  
of Assessments and Taxation  
State of Maryland

Pursuant to the provisions of Section 2-608 of the Maryland General Corporation Law,  
Allied Capital Corporation, a Maryland corporation (the "Corporation"), hereby certifies that:

FIRST: The Corporation desires to restate its charter (the "Charter") as  
currently in effect.

SECOND: The provisions set forth in these Articles of Restatement following the  
caption "Restated Articles of Incorporation of Allied Capital Corporation" are all of the  
provisions of the Charter currently in effect;

THIRD: The restatement of the Charter has been approved by a majority of  
the entire Board of Directors of the Corporation; and

FOURTH: The Charter is not amended by these Articles of Restatement.

FIFTH: The current address of the principal office of the Corporation in the  
State of Maryland is: 11 East Chase Street, Baltimore, Maryland, 21202.

SIXTH: The name and address of the current resident agent of the  
Corporation in the State of Maryland is: The Prentice-Hall Corporation System, Maryland,  
11 East Chase Street, Baltimore, Maryland, 21202.

SEVENTH: The number of directors of the Corporation is twelve and the names  
of the directors currently in office are: William L. Walton, Brooks H. Browne, John D.  
Firestone, Anthony T. Garcia, Lawrence I. Hebert, John I. Leahy, Robert E. Long, Warren  
K. Montouri, Guy T. Steuart II, T. Murray Toomey, Laura W. van Roijen and George C.  
Williams, Jr.

RESTATED ARTICLES OF INCORPORATION  
OF  
ALLIED CAPITAL CORPORATION

FIRST: The name of the corporation (hereinafter referred to as the "Corporation") is, Allied Capital Corporation.

SECOND: The purposes for which the Corporation is organized are as follows:

- A. To operate under the Small Business Investment Act of 1958, as amended, and the Small Business Act (1958), as amended, in the manner and with the powers and responsibilities, and subject to the limitations provided by, each such Act and the regulations issued by the U.S. Small Business Administration thereunder;
- B. To render advice and consulting services to corporations, individuals, partnerships, limited liability companies, business trusts and other business entities, to enter into contracts with any of such entities for the purpose of carrying out such advisory and consulting services; to register as an investment adviser with any agencies and in any jurisdictions; and to do all such other acts as may be related to or incidental to the purposes of an investment adviser, merchant bank or similar financial institution;
- C. To purchase, acquire, hold, own, improve, develop, sell, convey, assign, release, mortgage, encumber, use, lease, hire, manage, deal in and otherwise dispose of real property and personal property of every name and nature or any interest therein, improved or otherwise, including stocks and securities of other corporations; to loan money; to take securities for the payment of all sums due the Corporation; to sell, assign and release such securities;
- D. To engage in, operate and acquire interests in any kind of business, of whatever nature, which may be permitted by law;
- E. To do any act or thing and exercise any power suitable, convenient or proper for the accomplishment of any of the purposes set forth herein or incidental to such purposes, or which at any time may appear conducive to or expedient for the accomplishment of any of such purposes, and
- F. To have and exercise any and all powers and privileges now or hereafter conferred by the general laws of the State of Maryland upon corporations formed under such laws.

The foregoing enumeration of the purposes of the Corporation is made in furtherance and not in limitation of the powers conferred upon the Corporation by law. The mention of any particular purpose is not intended in any manner to limit or restrict the generality of any other purpose mentioned, or to limit or restrict any of the powers of the Corporation. The Corporation shall have, enjoy and exercise all of the powers and rights now or hereafter conferred by the laws of the State of Maryland upon corporations of a similar character, it being the intention that the purposes set forth in each of the paragraphs of this Article shall, except as otherwise expressly provided, in nowise be limited or restricted by reference to or inference from the terms of any other clause or paragraph of this or any other Article of these Articles of Incorporation, or of any amendment thereto, and shall each be regarded as independent, and construed as powers as well as purposes; provided, however, that nothing herein contained shall be

deemed to authorize or permit the Corporation to carry on any business or exercise any power, or do any act which a corporation formed under the general laws of the State of Maryland may not at the time lawfully carry on or do.

THIRD: [Intentionally omitted]

FOURTH:

A. The total number of shares of stock of all classes which the Corporation has the authority to issue is two hundred million (200,000,000) shares of capital stock, with a par value of One-Tenth of One Mil (\$0.0001) per share, amounting in aggregate to Twenty Thousand Dollars (\$20,000). All of such shares are initially classified as "Common Stock." The Board of Directors may classify and reclassify any unissued shares of capital stock by setting or changing in any one or more respects the preferences, conversion or other rights, voting powers, restrictions, limitations as to dividends, qualifications, terms or conditions of redemption or other rights of such shares of stock.

B. The following is a description of the preferences, conversion and other rights, voting powers, restrictions, limitations as to dividends, qualifications and terms and conditions of redemption of the Common Stock of the Corporation:

(1) Each share of Common Stock shall have one vote, and, except as otherwise provided in respect of any class of stock hereafter classified or reclassified, the exclusive voting power for all purposes shall be vested in the holders of the Common Stock,

(2) Subject to the provisions of law and any preferences of any class of stock hereafter classified or reclassified, dividends, including dividends payable in shares of another class of the Corporation's stock, may be paid on the Common Stock of the Corporation at such time and in such amounts as the Board of Directors may deem advisable, and

(3) In the event of any liquidation, dissolution or winding up of the Corporation, whether voluntary or involuntary, the holders of the Common Stock shall be entitled, after payment or provision for payment of the debt and other liabilities of the Corporation and the amount to which the holders of any class of stock hereafter classified or reclassified having a preference on distributions in the liquidation, dissolution or winding up of the Corporation shall be entitled, together with the holders of any other class of stock hereafter classified or reclassified not having a preference on distributions in the liquidation, dissolution or winding up of the Corporation, to share ratably in the remaining net assets of the Corporation.

C. Subject to the foregoing, the power of the Board of Directors to classify and reclassify any of the shares of capital stock shall include, without limitation, subject to the provisions of these Articles of Incorporation, as they may be subsequently be amended, authority to classify or reclassify any unissued shares of such stock into a class or classes of preferred stock, preference stock, special stock or other stock, and to divide and classify shares of any class into one or more series of such class, by determining, fixing or altering one or more of the following:

(1) The distinctive designation of such class or series and the number of shares to constitute such class or series; provided that, unless otherwise prohibited by the terms of any such or any other class or series, the number of shares of any class or series may be decreased by the Board of Directors in connection with any classification or reclassification of unissued shares and the number of shares of such class or series may be increased by the Board of Directors in connection with any such classification or reclassification, and any shares of any class or series which have been redeemed,

purchased, otherwise acquired or converted into shares of Common Stock or any other class or series shall become part of the authorized capital stock and be subject to classification and reclassification as provided in this sub-paragraph;

(2) Whether or not and, if so, the rates, amount and times at which, and the conditions under which, dividends shall be payable on shares of such class or series, whether any such dividends shall rank senior or junior to or on a parity with the dividends payable on any other class or series of stock, and the status of any such dividends as cumulative, cumulative to a limited extent, or non-cumulative and as participating or non-participating;

(3) Whether or not shares of such class or series shall have voting rights, in addition to any voting rights provided by law and, if so, the terms of such voting rights;

(4) Whether or not shares of such class or series shall have conversion or exchange privileges and, if so, the terms and conditions thereof, including provision for adjustment of the conversion or exchange rate in such events or at such times as the Board of Directors shall determine;

(5) Whether or not shares of such class or series shall be subject to redemption and, if so, the terms and conditions of such redemption, including the date or dates upon or after which they shall be redeemable and the amount per share payable in case of redemption, which amount may vary under different conditions and at different redemption dates; and whether or not there shall be any sinking fund or purchase account in respect thereof, and if so, the terms thereof;

(6) The rights of the holders of shares of such class or series upon the liquidation, dissolution or winding up of the affairs of, or upon any distribution of assets of, the Corporation, which rights may vary depending on whether such liquidation, dissolution or winding up is voluntary or involuntary, and, if voluntary, may vary at different dates, and whether such rights shall rank senior or junior to or on a parity with such rights of any other class or series of stock;

(7) Whether or not there shall be any limitations applicable, while shares of such class or series are outstanding, upon the payment of dividends or making of distributions on, or the acquisition of, or the use of moneys for purchase or redemption of, any stock of the Corporation, or upon any other action of the Corporation, including action under this sub-paragraph, and if so, the terms and conditions thereof; and

(8) Any other preferences, rights, restrictions, including restrictions on transferability, and qualifications of shares of such class or series, not inconsistent with law and the Articles of Incorporation, as they may subsequently be amended.

D. For the purposes hereof and of any Articles Supplementary to these Articles of Incorporation providing for the classification or reclassification of any shares of capital stock or of any other charter document of the Corporation (unless otherwise provided in any such articles or documents), any class or series of stock of the Corporation shall be deemed to rank:

(1) prior to another class or series either as to dividends or upon liquidation, if the holders of such class or series shall be entitled to the receipt of dividends or of amounts distributable on liquidation, dissolution or winding up, as the case may be, in preference or priority to holders of such other class or series;

(2) on a parity with another class or series either as to dividends or upon liquidation, whether or not the dividend rates, dividend payment dates or redemption or liquidation price per share thereof be different from those of such others, if the holders of such class or series of stock shall be entitled to receipt of dividends or amounts distributable upon liquidation, dissolution or winding up, as the case may be, in proportion to their respective dividend rates or redemption or liquidation prices, without preference or priority over the holders of such other class or series; and

(3) junior to another class or series as to dividends or upon liquidation, if the rights of the holders of such class or series shall be subject or subordinate to the rights of the holders of such other class or series in respect of the receipt of dividends or the amounts distributable upon liquidation, dissolution or winding up, as the case may be.

**FIFTH:** The number of directors of the Corporation shall be in accordance with the provisions of the General Corporation Law of the State of Maryland, which number may be changed pursuant to the provisions set forth in the Bylaws of the Corporation, but shall never be less than the number permitted by law.

**SIXTH:** The following provisions are hereby adopted for the purpose of defining, limiting and regulating the powers of the Corporation and of the Board of Directors and stockholders:

A. The Board of Directors of the Corporation is hereby empowered to authorize and direct the issuance from time to time or at any time or times of the shares of stock of the Corporation of any class, now or hereafter authorized, any options or warrants for such shares permitted by law, any rights to subscribe to or purchase such shares and any other securities of the Corporation, for such consideration as the Board of Directors may deem advisable, subject to such limitations and restrictions, if any, as may be set forth in the Bylaws of the Corporation.

B. Unless specifically provided elsewhere herein or in any Articles Supplementary, no holder of shares of stock of the Corporation of any class, now or hereafter authorized, shall have any preferential or preemptive right to subscribe for, purchase or receive (i) any shares of stock of the Corporation of any class, now or hereafter authorized, (ii) any options or warrants for such shares permitted by law, (iii) any rights to subscribe to or purchase such shares, or (iv) any other securities of the Corporation which may at any time or from time to time be issued, sold or offered for sale by the Corporation.

C. The Board of Directors of the Corporation is hereby empowered to adopt Bylaw provisions with respect to the indemnification of officers, employees, agents and other persons and to make such other indemnification as they shall deem expedient and in the best interests of the Corporation and to the extent permitted by law.

D. The provisions relating to certain special voting requirements set forth in Title 3, Subtitle 6 of the General Corporation Law of the State of Maryland and the provisions relating to certain control shares set forth in Title 3, Subtitle 7 of the General Corporation Law of the State of Maryland shall not be applicable, pursuant to Sections 3-603(a)(iii) and 3-702(b) thereof, respectively, to the shares of the Corporation which are owned by, or which shall in the future be issued to and owned by, any employee stock ownership plan, incentive stock ownership plan or other similar plan established now or in the future for the benefit of the Corporation's directors, officers, employees or affiliates, and, without limiting the foregoing, none of such shares owned by any such plan shall, for purposes of such subtitles, be aggregated with any shares owned individually by any beneficiaries of any such plan.



E. The Board of Directors of the Corporation is hereby authorized to make, amend, alter, repeal or rescind the Bylaws of the Corporation.

F. The Corporation reserves the right to amend these Articles of Incorporation in any way which alters the contract rights, as expressly set forth in these Articles of Incorporation, of any outstanding stock of the Corporation and substantially adversely affects any of the rights of any of the holders of any outstanding stock of the Corporation.

SEVENTH: A. The Corporation shall indemnify (i) its directors and officers, whether serving the Corporation or at its request any other entity, to the full extent permitted by the General Laws of the State of Maryland now or hereafter in force (as limited by the Investment Company Act of 1940, as amended, or by any valid rule, regulation or order of the Securities and Exchange Commission thereunder, in each case as now or hereafter in force (the "1940 Act")), including the advance of expenses under the procedures and to the full extent permitted by law, and (ii) other employees and agents to such extent as shall be authorized by the Board of Directors or the Corporation's Bylaws and be permitted by law. The foregoing rights of indemnification shall not be exclusive of any other rights to which those making indemnification may be entitled. The Board of Directors may take such action as is necessary to carry out these indemnification provisions and is expressly empowered to adopt, approve and amend from time to time such bylaws, resolutions or contracts implementing such provisions or such further indemnification arrangements as may be permitted by law. No amendment to or repeal of this Article SEVENTH shall limit or eliminate the right to indemnification provided hereunder with respect to acts or omissions occurring prior to such amendment or repeal.

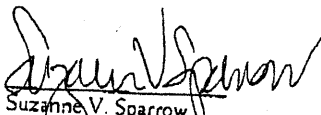
B. To the fullest extent permitted by Maryland statutory or decisional law, as amended or interpreted and as limited by the 1940 Act, no director or officer of the Corporation shall be personally liable to the Corporation or its stockholders for money damages. No amendment to or repeal of this Article SEVENTH shall limit or eliminate the benefits provided to directors and officers under this provision with respect to any act or omission which occurred prior to such amendment or repeal.

EIGHTH: The duration of the Corporation shall be perpetual.

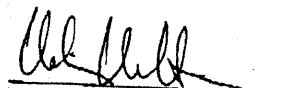
IN WITNESS WHEREOF, Allied Capital Corporation has caused these presents to be signed in its name and on its behalf by its President and attested by its Secretary on February 15, 2002.

ALLIED CAPITAL CORPORATION


Attest:

  
Suzanne V. Sparrow  
Secretary

By:

  
William L. Walton  
President

THE UNDERSIGNED, William L. Walton, President of Allied Capital Corporation, who executed on behalf of said corporation the foregoing Articles of Restatement, of which this certificate is made a part, hereby acknowledges, in the name and on behalf of said corporation, the foregoing Articles of Restatement to be the corporate act of said corporation and further certifies that, to the best of his knowledge, information, and belief, the matters and facts set forth therein with respect to the approval thereof are true in all material respects, under penalties of perjury.

  
William L. Walton

**CORPORATE CHARTER APPROVAL SHEET**  
**\*\* EXPEDITED SERVICE \*\***

**\*\* KEEP WITH DOCUMENT \*\***

DOCUMENT CODE 08 BUSINESS CODE \_\_\_\_\_

# D03077419

Close \_\_\_\_\_ Stock \_\_\_\_\_ Nonstock \_\_\_\_\_

P.A. \_\_\_\_\_ Religious \_\_\_\_\_

Merging (Transferor) \_\_\_\_\_

Surviving (Transferee) \_\_\_\_\_



ID # D03077419 ACK # 1000361986698235  
LIBER: B00349 FOLIO: 0696 PAGES: 0008  
ALLIED CAPITAL CORPORATION

02/26/2002 AT 08:31 A WO # 0000557759

New Name \_\_\_\_\_

**FEES REMITTED**

Base Fee: 20

Org. & Cap. Fee: \_\_\_\_\_

Expedite Fee: 70

Penalty: \_\_\_\_\_

State Recordation Tax: \_\_\_\_\_

State Transfer Tax: \_\_\_\_\_

1 Certified Copies 80

Copy Fee: 14

Certificates \_\_\_\_\_

Certificate of Status Fee: \_\_\_\_\_

Personal Property Filings: \_\_\_\_\_

Other: \_\_\_\_\_

TOTAL FEES: 104

Credit Card \_\_\_\_\_ Check ☒ Cash \_\_\_\_\_

1 Documents on 1 Checks

Approved By: 10

Keyed By: \_\_\_\_\_

COMMENT(S):

\_\_\_\_\_  
Change of Name  
\_\_\_\_\_  
Change of Principal Office  
\_\_\_\_\_  
Change of Resident Agent  
\_\_\_\_\_  
Change of Resident Agent Address  
\_\_\_\_\_  
Resignation of Resident Agent  
\_\_\_\_\_  
Designation of Resident Agent  
and Resident Agent's Address  
\_\_\_\_\_  
Change of Business Code

\_\_\_\_\_  
Adoption of Assumed Name

☒ Other Change(s)  
Current directors

Code 604

Attention: \_\_\_\_\_

Mail to Address: \_\_\_\_\_

**CERTIFIED  
COPY MADE**

Stamp Work Order and Customer Number HERE

CUST ID: 0000821840  
WORK ORDER: 0000557759  
DATE: 02-26-2002 01:46 PM  
AMT. PAID: \$104.00

ARTICLES OF AMENDMENT

TO THE

2000 NOV 17 A 10:44

AMENDED AND RESTATED ARTICLES OF INCORPORATION

OF

ALLIED CAPITAL CORPORATION

Pursuant to the provisions of the Maryland General Corporation Law, the undersigned corporation the "Corporation" adopts the following Articles of Amendment to its Amended and Restated Articles of Incorporation (the "Charter"):

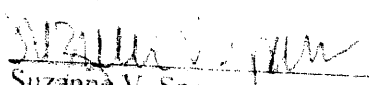
1. The name of the Corporation is Allied Capital Corporation.
2. The following amendment to the Charter was advised by the Corporation's board of directors and approved by the Corporation's shareholders at the special meeting of the Corporation's shareholders on November 15, 2000.
3. The first sentence of Article FOURTH Section A of the Charter is hereby amended and restated to reflect the increase of the total number of shares of all classes which the Corporation has authority to issue from one-hundred million (100,000,000) shares of capital stock, with a par value of One-Tenth of One Mil Dollars (\$0.0001) per share ("Shares") to two-hundred million (200,000,000) Shares as follows:

The total number of shares of stock of all classes which the Corporation has the authority to issue is two-hundred million (200,000,000) shares of capital stock, with a par value of One-Tenth of One Mil (\$0.0001) per share, amounting in aggregate to Twenty Thousand Dollars (\$20,000).

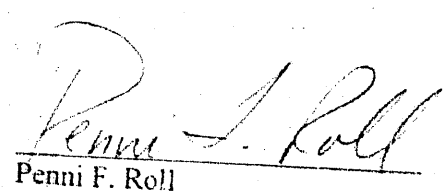
Date: November 16, 2000

ALLIED CAPITAL CORPORATION

Attest:

  
Suzanne V. Sparrow  
Secretary

By:

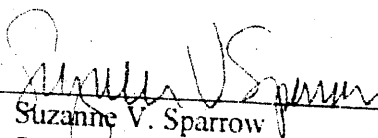
  
Penni F. Roll  
Executive Vice President and  
Chief Financial Officer

10 # 003077419 ACK # 1000245144000000  
LIBER 800198 FOLIO: 1556 PAGES: 0003  
ALLIED CAPITAL CORPORATION

11/17/2000 AT 10:44 A WO # 000038397

198-1556

THE UNDERSIGNED, Secretary of the Corporation witnessed the execution of the foregoing amendment to the Charter of which this certificate is made part, hereby verifies under oath, in the name and on behalf of the Corporation, that the foregoing amendment to the Charter is the corporate act of the Corporation and further certifies that, to the best of her knowledge, information and belief, the matters and facts set forth therein with respect to the approval thereof are true in all material respects, under the penalties of perjury.



Suzanne V. Sparrow  
Secretary

STATE OF MARYLAND  
DEPT OF ASSESSMENTS AND TAXATION  
CUST ID: 0000519153  
WORK ORDER: 0000383971  
DATE: 11-17-2000 01:13 PM  
AMT. PAID: \$70.00

**\*\* EXPEDITED SERVICE \*\***

**\*\* KEEP WITH DOCUMENT \*\***

DOCUMENT CODE 09

BUSINESS CODE \_\_\_\_\_

# 19 3077419

Close \_\_\_\_\_

Stock \_\_\_\_\_

Nonstock \_\_\_\_\_

P.A. \_\_\_\_\_

Religious \_\_\_\_\_

Merging (Transferor) \_\_\_\_\_

STATE OF PENNSYLVANIA

DEPT. OF ASSESSMENTS AND TAXATION

CUST ID: 0000519153

WORK ORDER: 0000383971

DATE: 11-17-2000 01:13 PM

AMT. PAID: \$70.00

Surviving (Transferee) \_\_\_\_\_

**FEES REMITTED**

Base Fee: 20

Org. & Cap. Fee: \_\_\_\_\_

Expedite Fee: 50

Penalty: \_\_\_\_\_

State Recordation Tax: \_\_\_\_\_

State Transfer Tax: \_\_\_\_\_

Certified Copies: \_\_\_\_\_

Copy Fee: \_\_\_\_\_

Certificates: \_\_\_\_\_

Certificate Fee: \_\_\_\_\_

Other: \_\_\_\_\_

TOTAL FEES: 70

(New Name) \_\_\_\_\_

Change of Name

Change of Principal Office

Change of Resident Agent

Change of Resident Agent Address

Resignation of Resident Agent

Designation of Resident Agent

and Resident Agent's Address

Change of Business Code

Adoption of Assumed Name

Other Change(s) \_\_\_\_\_

CODE 604

ATTENTION: \_\_\_\_\_

MAIL TO ADDRESS: \_\_\_\_\_

Credit Card \_\_\_\_\_

Check ☒

Cash \_\_\_\_\_

Documents on \_\_\_\_\_

Checks \_\_\_\_\_

APPROVED BY: [Signature]

KEYED BY: [Signature]

COMMENT(S): \_\_\_\_\_

**EXHIBIT B**

**Allied Capital Corporation:  
Financials**

**CLOSE WINDOW****PRINT PAGE**

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ALLIED CAPITAL CORP filed this on 08/14/2002.

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**FORM 10-Q****SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549****QUARTERLY REPORT PURSUANT TO  
SECTION 13 OR 15(d) OF  
THE SECURITIES EXCHANGE ACT OF 1934**

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**For The Quarterly Period  
Ended June 30, 2002****Commission File Number:  
0-22832****ALLIED CAPITAL CORPORATION***(Exact Name of Registrant as Specified in its Charter)***Maryland**  
*(State or Jurisdiction of  
Incorporation or Organization)***52-1081052**  
*(IRS Employer  
Identification No.)***1919 Pennsylvania Avenue, N.W.  
Washington, DC 20006**  
*(Address of Principal Executive Offices)***Registrant's telephone number, including area code: (202) 331-1112**

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Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 12 of 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter periods as the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES ☒ NO ☐

On August 13, 2002 there were 102,306,364 shares outstanding of the Registrant's common stock, \$0.0001 par value.

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**ALLIED CAPITAL CORPORATION**
**FORM 10-Q INDEX**
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**PART I: FINANCIAL INFORMATION**
**Item 1. Financial Statements**
**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**
**CONSOLIDATED BALANCE SHEET**

	June 30, 2002	December 31, 2001
(in thousands, except share and per share amounts)	(unaudited)	
<b>ASSETS</b>		
Portfolio at value:		
Private finance		
Companies more than 25% owned (cost: 2002-\$512,468; 2001-\$451,705)	\$ 632,560	\$ 505,620
Companies 5% to 25% owned (cost: 2002-\$235,879; 2001-\$211,030)	264,691	232,399
Companies less than 5% owned (cost: 2002-\$832,665; 2001-\$891,231)	738,008	857,053
Total private finance	1,635,259	1,595,072
Commercial real estate finance (cost: 2002-\$724,240; 2001-\$732,636)	745,710	734,518
Total portfolio at value	2,380,969	2,329,590
Other assets	183,328	130,234
Cash and cash equivalents	4,319	889
Total assets	<u>\$2,568,616</u>	<u>\$2,460,713</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Liabilities:		
Notes payable and debentures	\$ 869,200	\$ 876,056
Revolving credit facility	139,750	144,750
Accounts payable and other liabilities	118,213	80,784
Total liabilities	<u>1,127,163</u>	<u>1,101,590</u>
Commitments and Contingencies		
Preferred stock	7,000	7,000
Shareholders' equity:		
Common stock, \$0.0001 par value, 200,000,000 shares authorized; 102,296,392 and 99,607,396 shares issued and outstanding at June 30, 2002 and December 31, 2001, respectively	10	10
Additional paid-in capital	1,417,356	1,352,688
Notes receivable from sale of common stock	(28,190)	(26,028)
Net unrealized appreciation on portfolio	64,118	39,981
Distributions in excess of earnings	(18,841)	(14,528)
Total shareholders' equity	<u>1,434,453</u>	<u>1,352,123</u>
Total liabilities and shareholders' equity	<u>\$2,568,616</u>	<u>\$2,460,713</u>
Net asset value per common share	<u>\$ 14.02</u>	<u>\$ 13.57</u>

The accompanying notes are an integral part of these consolidated financial statements.

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF OPERATIONS

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2002	2001	2002	2001
(in thousands, except per share amounts)	(unaudited)		(unaudited)	
Interest and related portfolio income:				
Interest and dividends				
Companies more than 25% owned	\$ 9,342	\$ 5,280	\$ 18,806	\$ 10,888
Companies 5% to 25% owned	7,305	6,680	14,385	12,911
Companies less than 5% owned	46,045	46,864	94,474	89,900
Total interest and dividends	62,692	58,824	127,665	113,699
Premiums from loan dispositions				
Companies more than 25% owned	—	—	—	511
Companies less than 5% owned	46	910	1,659	1,220
Total premiums from loan dispositions	46	910	1,659	1,731
Fees and other income				
Companies more than 25% owned	6,890	4,284	13,865	8,113
Companies 5% to 25% owned	476	150	476	150
Companies less than 5% owned	3,089	4,571	11,919	10,117
Total fees and other income	10,455	9,005	26,260	18,380
Total interest and related portfolio income	73,193	68,739	155,584	133,810
Expenses:				
Interest	17,515	15,951	34,984	31,881
Employee	8,274	7,610	16,309	14,056
Administrative	4,843	3,060	7,861	6,027
Total operating expenses	30,632	26,621	59,154	51,964
Net investment income before net realized and unrealized gains	42,561	42,118	96,430	81,846
Net realized and unrealized gains (losses):				
Net realized gains (losses)				
Companies more than 25% owned	(630)	(731)	(630)	(731)
Companies 5% to 25% owned	—	4,571	718	4,571
Companies less than 5% owned	(125)	(3)	8,762	1,151
Total net realized gains (losses)	(755)	3,837	8,850	4,991
Net unrealized gains	31,648	151	24,135	11,297
Total net realized and unrealized gains	30,893	3,988	32,985	16,288
Net increase in net assets resulting from operations	\$ 73,454	\$46,106	\$129,415	\$ 98,134
Basic earnings per common share	\$ 0.72	\$ 0.52	\$ 1.28	\$ 1.12
Diluted earnings per common share	\$ 0.71	\$ 0.51	\$ 1.26	\$ 1.10
Weighted average common shares outstanding — basic	101,660	89,356	100,822	87,441
Weighted average common shares outstanding — diluted	103,440	90,848	102,900	88,966

The accompanying notes are an integral part of these consolidated financial statements.

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF CHANGES IN NET ASSETS**

(in thousands, except per share amounts)	For the Six Months Ended June 30,	
	2002	2001
	(unaudited)	
Operations:		
Net investment income before net realized and unrealized gains	\$ 96,430	\$ 81,846
Net realized gains	8,850	4,991
Net unrealized gains	24,135	11,297
Net increase in net assets resulting from operations	129,415	98,134
Shareholder distributions:		
Common stock dividends	(109,482)	(87,836)
Preferred stock dividends	(110)	(110)
Net decrease in net assets resulting from shareholder distributions	(109,592)	(87,946)
Capital share transactions:		
Sale of common stock	49,920	123,262
Issuance of common stock upon the exercise of stock options	11,626	6,258
Issuance of common stock in lieu of cash distributions	3,123	3,415
Net increase in notes receivable from sale of common stock	(2,162)	(1,154)
Net increase in net assets resulting from capital share transactions	62,507	131,781
Total increase in net assets	\$ 82,330	\$ 141,969
Net assets at beginning of period	\$1,352,123	\$1,029,692
Net assets at end of period	\$1,434,453	\$1,171,661
Net asset value per common share	\$ 14.02	\$ 12.79
Common shares outstanding at end of period	102,296	91,578

The accompanying notes are an integral part of these consolidated financial statements.

**CONSOLIDATED STATEMENT OF CASH FLOWS**

	<b>For the Six Months Ended June 30,</b>	
	<b>2002</b>	<b>2001</b>
<b>(in thousands)</b>		
	<b>(unaudited)</b>	
Cash flows from operating activities:		
Net increase in net assets resulting from operations	\$ 129,415	\$ 98,134
Adjustments		
Portfolio investments	(195,455)	(299,843)
Repayments of investment principal	67,017	42,544
Proceeds from investment sales	126,280	74,648
Change in accrued or reinvested interest and dividends	(19,463)	(25,493)
Changes in other assets and liabilities	(18,982)	(7,374)
Amortization of loan discounts and fees	(9,284)	(7,722)
Depreciation and amortization	657	479
Realized losses	6,579	1,605
Net unrealized gains	(24,135)	(11,297)
Net cash provided by (used in) operating activities	62,629	(134,319)
Cash flows from financing activities:		
Sale of common stock	49,920	123,262
Sale of common stock upon the exercise of stock options	9,245	2,103
Collections of notes receivable from sale of common stock	220	3,002
Common dividends and distributions paid	(106,359)	(84,422)
Preferred stock dividends paid	(110)	(110)
Net borrowings under (repayments on) notes payable and debentures	(6,856)	11,666
Net borrowings under (repayments on) revolving line of credit	(5,000)	82,750
Other	(259)	(2,948)
Net cash provided by (used in) financing activities	(59,199)	135,303
Net increase in cash and cash equivalents	\$ 3,430	\$ 984
Cash and cash equivalents at beginning of period	\$ 889	\$ 2,449
Cash and cash equivalents at end of period	\$ 4,319	\$ 3,433

The accompanying notes are an integral part of these consolidated financial statements.

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENT OF INVESTMENTS**

		June 30, 2002	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	(unaudited)	
		Cost	Value
<b>Companies More Than 25% Owned</b>			
Acme Paging, L.P. (Telecommunications)	Loan	\$ 3,200	\$ 3,200
	Debt Securities	7,005	7,005
	Equity Interests	3,717	2,261
American Healthcare Services, Inc. (Healthcare)	Debt Securities	41,362	41,362
	Common Stock (79,567,042 shares)	1,000	100
	Guaranty (\$915)	—	—
Business Loan Express, Inc. (Financial Services)	Loan	6,000	6,000
	Debt Securities	80,809	80,809
	Preferred Stock (25,111 shares)	25,111	25,111
	Common Stock (25,503,043 shares)	104,641	140,000
	Guaranty (\$48,126 — See Note 3)	—	—
	Standby Letters of Credit (\$10,550 — See Note 3)	—	—
The Color Factory Inc. (Consumer Products)	Loan	7,439	7,439
	Preferred Stock (1,000 shares)	1,002	1,002
	Common Stock (980 shares)	6,535	8,035
Directory Investment Corporation (Publishing)	Common Stock (470 shares)	112	32
Directory Lending Corporation (Publishing)	Series A Common Stock (34 shares)	—	—
	Series B Common Stock (6 shares)	8	—
	Series C Common Stock (10 shares)	22	—
EDM Consulting, LLC (Business Services)	Debt Securities	1,875	443
	Equity Interests	250	—
Elmhurst Consulting, LLC (Business Services)	Loan	12,530	12,530
	Equity Interests	5,165	5,165
	Guaranty (\$2,190)	—	—
Foresite Towers, LLC (Tower Leasing)	Equity Interests	15,522	15,522
Gordian Group, Inc. (Business Services)	Loan	6,965	6,965
	Common Stock (1,000 shares)	1,300	1,300
HealthASPex, Inc. (Business Services)	Preferred Stock (1,451,380 shares)	4,900	2,617
	Preferred Stock (700,000 shares)	700	700
	Common Stock (1,451,380 shares)	4	—
The Hillman Companies Inc.(1) (Consumer Products)	Debt Securities	41,012	41,012
	Common Stock (6,890,937 shares)	57,156	90,000

(1) Public company.

(2) Common stock, preferred stock, warrants, options and equity interests are generally non-income producing and restricted.

(3) Non-U.S. company.

(4) Non-registered investment company.

The accompanying notes are an integral part of these consolidated financial statements.

		June 30, 2002	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	(unaudited)	
		Cost	Value
xHMT, Inc. (Business Services)	Debt Securities	\$ 9,036	\$ 9,036
	Preferred Stock (519,484 shares)	2,078	2,078
	Common Stock (300,000 shares)	3,000	1,694
	Warrants	1,155	651
Monitoring Solutions, Inc. (Business Services)	Debt Securities	1,823	153
	Common Stock (33,333 shares)	—	—
	Warrants	—	—
MVL Group, Inc. (Business Services)	Loan	16,963	16,963
	Debt Securities	16,116	16,116
	Common Stock (650,000 shares)	643	643
Spa Lending Corporation (Recreation)	Preferred Stock (28,625 shares)	409	288
	Common Stock (6,208 shares)	—	—
STS Operating, Inc. (Industrial Products)	Common Stock (3,000,000 shares)	3,177	3,177
Sure-Tel, Inc. (Consumer Services)	Preferred Stock (1,000,000 shares)	1,000	1,000
	Common Stock (37,000 shares)	5,018	5,018
Total Foam, Inc. (Industrial Products)	Debt Securities	260	125
	Common Stock (910 shares)	10	—
WyoTech Acquisition Corporation (Education)	Debt Securities	12,638	12,638
	Preferred Stock (100 shares)	3,700	3,700
	Common Stock (99 shares)	100	60,670
<b>Total companies more than 25% owned</b>		<b>\$512,468</b>	<b>\$632,560</b>
<b>Companies 5% to 25% Owned</b>			
Aspen Pet Products, Inc. (Consumer Products)	Loans	\$ 15,111	\$ 15,111
	Preferred Stock (2,021 shares)	1,981	1,981
	Common Stock (1,400 shares)	140	140
Autania AG(1,3) (Industrial Products)	Debt Securities	4,487	4,487
	Common Stock (250,000 shares)	2,169	2,169
CBA-Mezzanine Capital Finance, LLC (Financial Services)	Loan	313	313
Colibri Holding Corporation (Consumer Products)	Loans	3,478	3,478
	Preferred Stock (237 shares)	248	248
	Common Stock (3,362 shares)	1,250	1,250
	Warrants	290	290
CorrFlex Graphics, LLC (Business Services)	Debt Securities	2,393	2,393
	Warrants	—	17,490
	Options	—	1,510
Csabai Canning Factory Rt(3) (Consumer Products)	Hungarian Quotas (9.2%)	700	—

(1) Public company.

(2) Common stock, preferred stock, warrants, options and equity interests are generally non-income

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(4) Non-registered investment company.

The accompanying notes are an integral part of these consolidated financial statements.

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Private Finance Portfolio Company (in thousands, except number of shares)		June 30, 2002	
		(unaudited)	
	Investment(2)	Cost	Value
CyberRep (Business Services)	Loan	\$ 1,184	\$ 1,184
	Debt Securities	14,550	14,550
	Warrants	660	3,310
The Debt Exchange Inc. (Business Services)	Preferred Stock (921,829 shares)	1,250	1,250
Gibson Guitar Corporation (Consumer Products)	Debt Securities	17,558	17,558
	Warrants	525	2,325
International Fiber Corporation (Industrial Products)	Debt Securities	22,499	22,499
	Common Stock (1,029,068 shares)	5,483	6,982
	Warrants	550	700
Liberty-Pittsburgh Systems, Inc. (Business Services)	Debt Securities	3,494	3,494
	Common Stock (123,929 shares)	142	142
Litterer Beteiligungs-GmbH(3) (Business Services)	Debt Securities	1,070	1,070
	Equity Interest	358	358
Logic Bay Corporation (Business Services)	Preferred Stock (1,131,222 shares)	5,000	1,000
Magna Card, Inc. (Consumer Products)	Debt Securities	153	153
	Preferred Stock (1,875 shares)	94	94
	Common Stock (4,687 shares)	—	—
Master Plan, Inc. (Business Services)	Loan	1,204	1,204
	Common Stock (156 shares)	42	42
MortgageRamp.com, Inc. (Business Services)	Common Stock (772,000 shares)	3,860	3,860
Morton Grove Pharmaceuticals, Inc. (Consumer Products)	Loan	16,356	16,356
	Preferred Stock (106,947 shares)	5,000	12,000
Nobel Learning Communities, Inc.(1) (Education)	Debt Securities	9,704	9,704
	Preferred Stock (1,063,830 shares)	2,000	2,000
	Warrants	575	296
North American Archery, LLC (Consumer Products)	Loans	1,390	840
	Convertible Debentures	2,248	59
	Guaranty (\$1,020)	—	—
Packaging Advantage Corporation (Business Services)	Debt Securities	11,635	11,635
	Common Stock (200,000 shares)	2,000	2,000
	Warrants	963	963
Professional Paint, Inc. (Consumer Products)	Debt Securities	22,086	22,086
	Preferred Stock (15,000 shares)	18,309	18,309
	Common Stock (110,000 shares)	69	4,500



- (1) Public company.  
 (2) Common stock, preferred stock, warrants, options and equity interests are generally non-income producing and restricted.  
 (3) Non-U.S. company.  
 (4) Non-registered investment company.

The accompanying notes are an integral part of these consolidated financial statements.

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		June 30, 2002	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	(unaudited)	
		Cost	Value
Progressive International Corporation (Consumer Products)	Debt Securities Preferred Stock (500 shares) Common Stock (197 shares) Warrants	\$ 3,963 500 13 —	\$ 3,963 500 13 —
Redox Brands, Inc. (Consumer Products)	Debt Securities Preferred Stock (2,404,086 shares) Warrants	9,649 6,974 584	9,649 6,974 584
Staffing Partners Holding Company, Inc. (Business Services)	Loan Debt Securities Preferred Stock (414,600 shares) Common Stock (50,200 shares) Warrants	2,500 4,992 2,073 50 10	2,500 4,992 2,073 50 10
<b>Total companies 5% to 25% owned</b>		<b>\$235,879</b>	<b>\$264,691</b>
<b>Companies Less Than 5% Owned</b>			
ACE Products, Inc. (Industrial Products)	Loans	\$ 17,164	\$ 15,839
Advantage Mayer, Inc. (Business Services)	Debt Securities Warrants	10,654 382	10,654 1,455
Alderwoods Group, Inc.(1) (Consumer Services)	Common Stock (357,568 shares)	5,006	2,739
Allied Office Products, Inc. (Business Services)	Debt Securities Warrants	7,628 629	50 —
American Barbecue & Grill, Inc. (Retail)	Warrants	125	—
American Home Care Supply, LLC (Consumer Products)	Debt Securities Warrants	6,935 579	6,935 1,579
ASW Holding Corporation (Industrial Products)	Warrants	25	25
Avborne, Inc. (Business Services)	Debt Securities Warrants	12,959 1,180	3,500 —
Bakery Chef, Inc. (Consumer Products)	Loans	17,604	17,604
Blue Rhino Corporation(1) (Consumer Products)	Debt Securities Warrants	13,913 1,200	13,913 13,500
Border Foods, Inc.	Debt Securities	9,347	9,347

(Consumer Products)	Preferred Stock (50,919 shares)	2,000	2,000
	Warrants	665	665
Camden Partners Strategic Fund II, L.P. (4) (Private Equity Fund)	Limited Partnership Interest	1,879	2,002

(1) Public company.

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(3) Non-U.S. company.

(4) Non-registered investment company.

The accompanying notes are an integral part of these consolidated financial statements.

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		June 30, 2002	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	(unaudited)	
		Cost	Value
Candlewood Hotel Company(1) (Hospitality)	Preferred Stock (3,250 shares)	\$ 3,250	\$ 1,300
Celebrities, Inc. (Broadcasting & Cable)	Loan	230	230
	Warrants	12	492
Component Hardware Group, Inc. (Industrial Products)	Debt Securities	11,032	11,032
	Preferred Stock (18,000 shares)	1,800	1,800
	Common Stock (2,000 shares)	200	200
Convenience Corporation of America (Retail)	Debt Securities	8,355	2,738
	Preferred Stock (22,301 shares)	334	—
	Warrants	—	—
Cooper Natural Resources, Inc. (Industrial Products)	Loan	299	299
	Debt Securities	1,815	1,815
	Preferred Stock (6,316 shares)	1,427	1,427
	Warrants	832	832
Coverall North America, Inc. (Business Services)	Loan	10,418	10,418
	Debt Securities	5,740	5,740
CPM Acquisition Corporation (Industrial Products)	Loan	9,902	9,902
CTT Holdings (Consumer Products)	Loan	1,478	1,478
Cumulus Media, Inc. (1) (Broadcasting & Cable)	Common Stock (11,037 shares)	198	152
Drilltec Patents & Technologies Company, Inc. (Industrial Products)	Loan	10,918	348
	Debt Securities	1,500	1,500
	Warrants	—	—
eCentury Capital Partners, L.P.(4) (Private Equity Fund)	Limited Partnership Interest	1,875	1,691
El Dorado Communications, Inc. (Broadcasting & Cable)	Loans	306	306
Elaxis Beta GmbH(3) (Industrial Products)	Options	426	426

Epartin S.A.(3) (Consumer Products)	Loan	29	29
E-Talk Corporation (Business Services)	Debt Securities	8,852	1,000
	Warrants	1,157	—
Executive Greetings, Inc. (Business Services)	Debt Securities	17,327	17,327
	Warrants	360	360
ExTerra Credit Recovery, Inc. (Business Services)	Preferred Stock (500 shares)	568	103
	Common Stock (2,500 shares)	—	—
	Warrants	—	—

(1) Public company.

(2) Common stock, preferred stock, warrants, options and equity interests are generally nonincome producing and restricted.

(3) Non-U.S. company.

(4) Non-registered investment company.

The accompanying notes are an integral part of these consolidated financial statements.

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		June 30, 2002	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	(unaudited)	
		Cost	Value
Fairchild Industrial Products Company (Industrial Products)	Debt Securities	\$ 5,906	\$ 5,906
	Warrants	280	1,100
Galaxy American Communications, LLC (Broadcasting & Cable)	Debt Securities	48,433	34,010
	Options	—	—
	Standby Letter of Credit (\$750)	—	—
Garden Ridge Corporation (Retail)	Debt Securities	27,070	27,070
	Preferred Stock (1,130 shares)	1,130	1,130
	Common Stock (188,400 shares)	613	613
GC-Sun Holdings II, LP (Kar Products, LP) (Business Services)	Loans	8,167	8,167
Ginsey Industries, Inc. (Consumer Products)	Loans	5,000	5,000
	Convertible Debentures	500	500
	Warrants	—	1,500
Global Communications, LLC (Business Services)	Loan	1,997	1,997
	Debt Securities	15,262	15,262
	Equity Interest	11,067	11,067
	Options	1,639	1,639
Grant Broadcasting Systems II (Broadcasting & Cable)	Warrants	87	3,000
Grotech Partners, VI, L.P.(4) (Private Equity Fund)	Limited Partnership Interest	1,832	1,398
The Hartz Mountain Corporation (Consumer Products)	Debt Securities	27,544	27,544
	Common Stock (200,000 shares)	2,000	2,000
	Warrants	2,613	2,613
Hotelevision, Inc. (Broadcasting & Cable)	Preferred Stock (315,100 shares)	315	315

Icon International, Inc. (Business Services)	Common Stock (35,228 shares)	1,219	2,712
Impact Innovations Group, LLC (Business Services)	Debt Securities	6,727	3,436
	Warrants	1,674	—
Intellirisk Management Corporation (Business Services)	Loans	22,796	22,796
Interline Brands, Inc. (Business Services)	Debt Securities	33,431	33,431
	Preferred Stock (199,313 shares)	1,849	1,849
	Common Stock (15,615 shares)	139	139
	Warrants	1,181	1,181
Jakel, Inc. (Industrial Products)	Loan	23,307	16,047

(1) Public company.

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(3) Non-U.S. company.

(4) Non-registered investment company.

The accompanying notes are an integral part of these consolidated financial statements.

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		June 30, 2002	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	(unaudited)	
		Cost	Value
JRI Industries, Inc. (Industrial Products)	Debt Securities	\$ 1,981	\$ 1,981
	Warrants	74	74
Julius Koch USA, Inc. (Industrial Products)	Debt Securities	453	453
	Warrants	259	8,000
Kirker Enterprises, Inc. (Industrial Products)	Warrants	348	3,501
	Equity Interest	4	4
Kirkland's, Inc. (Retail)	Debt Securities	6,387	6,387
	Preferred Stock (917 shares)	412	412
	Warrants	96	5,816
Kyrus Corporation (Business Services)	Debt Securities	7,380	7,380
	Warrants	348	348
Love Funding Corporation (Financial Services)	Preferred Stock (26,000 shares)	359	213
Matrics, Inc. (Business Services)	Preferred Stock (511,876 shares)	500	500
	Warrants	—	—
MedAssets.com, Inc. (Business Services)	Debt Securities	15,363	15,363
	Preferred Stock (260,417 shares)	2,049	2,049
	Warrants	136	136
Mid-Atlantic Venture Fund IV, L.P.(4) (Private Equity Fund)	Limited Partnership Interest	2,475	1,479
Midview Associates, L.P. (Housing)	Warrants	—	—
Most Confiserie GmbH & Co KG(3) (Consumer Products)	Loan	950	50

<b>(Consumer Products)</b>			
NetCare, AG(3)	Loan	760	50
(Business Services)	Common Stock (262,784 shares)	230	—
NETtel Communications, Inc.	Debt Securities and Receivables	11,334	4,334
(Telecommunications)			
Northeast Broadcasting Group, L.P.	Debt Securities	289	289
(Broadcasting & Cable)			
Novak Biddle Venture Partners III, L.P.	Limited Partnership Interest		
(4)		420	420
(Private Equity Fund)			
Nursefinders, Inc.	Debt Securities	11,151	11,151
(Business Services)	Warrants	900	3,060
Onyx Television GmbH(3)	Preferred Units (120,000 shares)	201	8
(Broadcasting & Cable)			

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		<b>June 30, 2002</b>	
<b>Private Finance Portfolio Company (in thousands, except number of shares)</b>	<b>Investment(2)</b>	<b>(unaudited)</b>	
		<b>Cost</b>	<b>Value</b>
Opinion Research Corporation(1)	Debt Securities	\$14,269	\$14,269
(Business Services)	Warrants	996	881
Oriental Trading Company, Inc.	Debt Securities	12,920	12,920
(Consumer Products)	Preferred Equity Interest	1,500	1,500
	Common Equity Interest	—	2,000
	Warrants	13	2,300
Outsource Partners, Inc.	Debt Securities	24,048	24,048
(Business Services)	Warrants	826	826
Pico Products, Inc.	Loan	1,406	1,406
(Industrial Products)			
Polaris Pool Systems, Inc.	Debt Securities	10,630	10,630
(Consumer Products)	Warrants	1,145	1,145
Powell Plant Farms, Inc.	Loan	19,095	14,087
(Consumer Products)			
Proeducation GmbH(3)	Loan	321	321
(Education)			
Prosperco Finanz Holding AG(3)	Convertible Debentures	5,492	5,492
(Financial Services)	Common Stock (1,528 shares)	1,059	1,059
	Warrants	—	—
Raytheon Aerospace, LLC	Debt Securities	5,130	5,130
(Business Services)	Equity Interest	—	—
Schwinn Holdings Corporation	Debt Securities	10,195	1,835
(Consumer Products)			

(Consumer Products)			
Seasonal Expressions, Inc. (Consumer Products)	Preferred Stock (504 shares)	500	—
Simula, Inc.(1) (Industrial Products)	Loan	20,539	20,539
Soff-Cut Holdings, Inc. (Industrial Products)	Debt Securities	8,807	8,807
	Preferred Stock (300 shares)	300	300
	Common Stock (2,000 shares)	200	200
Southwest PCS, LLC (Telecommunications)	Loan	6,059	6,059
Startec Global Communications Corporation(1) (Telecommunications)	Loan	23,815	23,815
	Debt Securities	21,432	245
	Common Stock (258,064 shares)	3,000	—
	Warrants	—	—
SunStates Refrigerated Services, Inc. (Warehouse Facilities)	Loans	6,062	4,188
	Debt Securities	2,445	—

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(3) Non-U.S. company.

(4) Non-registered investment company.

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Private Finance Portfolio Company (in thousands, except number of shares)		June 30, 2002	
		(unaudited)	
	Investment(2)	Cost	Value
Sydran Food Services II, L.P. (Retail)	Debt Securities	\$ 12,973	\$ 12,973
	Equity Interests	3,909	3,909
	Warrants	—	—
Tubbs Snowshoe Company, LLC (Consumer Products)	Debt Securities	3,920	3,920
	Equity Interests	500	500
	Warrants	54	54
United Pet Group, Inc. (Consumer Products)	Debt Securities	8,987	8,987
	Warrants	85	85
Updata Venture Partners, II, L.P.(4) (Private Equity Fund)	Limited Partnership Interest	2	1,492
Velocita, Inc. (Telecommunications)	Debt Securities	11,718	—
	Warrants	3,540	—
Venturehouse Group, LLC(4) (Private Equity Fund)	Equity Interest	667	380
Walker Investment Fund II, LLLP(4) (Private Equity Fund)	Limited Partnership Interest	1,200	943
Warn Industries, Inc. (Consumer Products)	Debt Securities	11,513	11,513
	Warrants	1,429	3,129
Williams Brothers Lumber Company	Warrants	24	100

Company (Retail)			
Wilshire Restaurant Group, Inc. (Retail)	Debt Securities	15,630	15,630
	Warrants	735	735
Wilton Industries, Inc. (Consumer Products)	Loan	12,000	12,000
Woodstream Corporation (Consumer Products)	Loan	2,621	2,621
	Debt Securities	7,653	7,653
	Equity Interests	1,700	4,547
	Warrants	450	1,203
<b>Total companies less than 5% owned</b>		<b>\$ 832,665</b>	<b>\$ 738,008</b>
<b>Total private finance (133 portfolio companies)</b>		<b>\$1,581,012</b>	<b>\$1,635,259</b>

(1) Public company.

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(3) Non-U.S. company.

(4) Non-registered investment company.

The accompanying notes are an integral part of these consolidated financial statements.

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			June 30, 2002 (unaudited)	
(in thousands, except number of loans)	Stated Interest	Face	Cost	Value
<b>Commercial Real Estate Finance</b>				
<b>Commercial Mortgage-Backed Securities</b>				
<b>CMBS Bonds</b>				
Mortgage Capital Funding, Series 1998-MC3	5.5%	\$ 54,491	\$ 27,330	\$ 27,344
Morgan Stanley Capital I, Series 1999-RM1	6.4%	51,046	21,553	21,395
COMM 1999-1	5.6%	74,879	36,316	36,409
Morgan Stanley Capital I, Series 1999-FNV1	6.1%	37,752	16,811	16,804
DLJ Commercial Mortgage Trust 1999-CG2	6.1%	83,210	36,674	36,783
Commercial Mortgage Acceptance Corp., Series 1999-C1	6.8%	34,856	16,301	16,340
LB Commercial Mortgage Trust, Series 1999-C2	6.7%	29,005	11,576	12,188
Chase Commercial Mortgage Securities Corp., Series 1999-2	6.5%	37,430	16,579	17,426
FUNB CMT, Series 1999-C4	6.5%	43,372	18,259	18,865
Heller Financial, HFCMC Series 2000 PH-1	6.8%	45,456	18,516	19,319
SBMS VII, Inc., Series 2000-NL1	7.2%	20,804	10,764	11,309
DLJ Commercial Mortgage Trust, Series 2000-CF1	7.0%	38,685	18,345	19,030
Deutsche Bank Alex. Brown, Series Comm 2000-C1	6.9%	39,379	17,523	18,722
LB-UBS Commercial Mortgage Trust, Series 2000-C4	6.9%	34,967	12,617	14,000
Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CK1	5.9%	43,288	18,139	19,741
JP Morgan-CIBC-Deutsche 2001	5.8%	46,326	19,788	20,430
Lehman Brothers-UBS Warburg 2001-C4	6.4%	49,582	21,989	24,069
SBMS VII, Inc., Series 2001-C1	6.1%	41,109	16,017	16,774
GE Capital Commercial Mortgage Securities Corp., Series 2001-2	6.1%	45,218	19,947	20,699
Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CKN5	5.2%	59,602	28,245	29,518

JP Morgan Chase Commercial Mortgage Securities Corp., Series 2001-C1	5.6%	42,747	16,142	16,881
SBMS VII, Inc., Series 2001-C2	6.2%	47,353	22,043	24,180
FUNB CMT, Series 2002-C1	6.0%	38,238	16,592	17,630
GE Capital Commercial Mortgage Corp., Series 2002-1	6.2%	80,490	44,316	48,976
GMAC Commercial Mortgage Securities, Inc., Series 2002-C2	5.8%	62,704	34,643	36,058
<b>Total CMBS bonds</b>		<b>\$1,181,989</b>	<b>\$537,025</b>	<b>\$560,890</b>
<b>Collateralized Debt Obligations</b>				
Crest 2001-1, Ltd.(3)		24,023	24,023	24,023
Crest 2002-1, Ltd.(3)		23,541	23,541	23,541
Crest 2002-IG, Ltd.(3)		4,969	4,969	4,969
<b>Total collateralized debt obligations</b>		<b>\$ 52,533</b>	<b>\$ 52,533</b>	<b>\$ 52,533</b>
<b>Total CMBS</b>		<b>\$1,234,522</b>	<b>\$589,558</b>	<b>\$613,423</b>

	Interest Rate Ranges	Number of Loans	Cost	Value
<b>Commercial Mortgage Loans</b>				
	Up to 6.99%	9	\$ 8,108	\$ 9,122
	7.00%- 8.99%	19	21,252	20,555
	9.00%-10.99%	10	9,879	9,879
	11.00%-12.99%	10	14,746	14,540
	13.00%-14.99%	6	7,856	7,856
	15.00% and above	1	49	49
<b>Total commercial mortgage loans</b>		<b>55</b>	<b>\$ 61,890</b>	<b>\$ 62,001</b>
<b>Residual Interest</b>			<b>\$ 69,341</b>	<b>\$ 69,042</b>
<b>Real Estate Owned</b>			<b>3,451</b>	<b>1,244</b>
<b>Total commercial real estate finance</b>			<b>\$ 724,240</b>	<b>\$ 745,710</b>
<b>Total portfolio</b>			<b>\$2,305,252</b>	<b>\$2,380,969</b>

(3) Non-U.S. company.

The accompanying notes are an integral part of these consolidated financial statements.

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

### CONSOLIDATED STATEMENT OF INVESTMENTS

Private Finance Portfolio Company		December 31, 2001	
(in thousands, except number of shares)	Investment(2)	Cost	Value
Companies More Than 25% Owned			
Acme Paging, L.P. (Telecommunications)	Debt Securities	\$ 6,992	\$ 6,992
	Equity Interests	3,640	2,184
American Healthcare Services, Inc. (Healthcare)	Debt Securities	40,194	40,194
	Common Stock (79,567,042 shares)	1,000	100
	Guaranty (\$195)	—	—
Business Loan Express, Inc. (Financial Services)	Loan	6,000	6,000
	Debt Securities	76,242	76,242
	Preferred Stock (25 111 shares)	25 111	25 111



	Preferred Stock (25,111 shares)	25,111	25,111
	Common Stock (25,503,043 shares)	104,596	120,096
	Guaranty (\$51,350 — See Note 3)	—	—
The Color Factory Inc. (Consumer Products)	Loan	5,346	5,346
	Preferred Stock (600 shares)	788	788
	Common Stock (980 shares)	6,535	8,035
Directory Investment Corporation (Publishing)	Common Stock (470 shares)	112	32
Directory Lending Corporation (Publishing)	Series A Common Stock (34 shares)	—	—
	Series B Common Stock (6 shares)	8	—
	Series C Common Stock (10 shares)	22	—
EDM Consulting, LLC (Business Services)	Debt Securities	1,875	443
	Equity Interest	250	—
Elmhurst Consulting, LLC (Business Services)	Loan	7,762	7,762
	Equity Interests	5,157	5,157
	Guaranty (\$2,800)	—	—
Foresite Towers, LLC (Tower Leasing)	Equity Interests	15,500	15,500
HealthASPex, Inc. (Business Services)	Preferred Stock (1,451,380 shares)	4,900	3,900
	Preferred Stock (611,923 shares)	612	612
	Common Stock (1,451,380 shares)	4	—
The Hillman Companies, Inc. (Consumer Products)	Debt Securities	40,071	40,071
	Common Stock (6,890,937 shares)	57,156	57,156
HMT, Inc. (Business Services)	Debt Securities	8,995	8,995
	Common Stock (300,000 shares)	3,000	3,000
	Warrants	1,155	1,155
Monitoring Solutions, Inc. (Business Services)	Debt Securities	1,823	153
	Common Stock (33,333 shares)	—	—
	Warrants	—	—

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(3) Non-U.S. company.

(4) Non-registered investment company.

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Private Finance Portfolio Company		December 31, 2001	
(in thousands, except number of shares)	Investment(2)	Cost	Value
Spa Lending Corporation (Recreation)	Preferred Stock (28,625 shares)	\$ 485	\$ 375
	Common Stock (6,208 shares)	25	18
STS Operating, Inc. (Industrial Products)	Common Stock (3,000,000 shares)	3,177	3,177
Sure-Tel, Inc. (Consumer Services)	Loan	1,207	1,207
	Preferred Stock (1,116,902 shares)	4,642	4,642
	Warrants	662	662
	Options	—	—
Total Foam, Inc.	Debt Securities	263	127

(Industrial Products)	Common Stock (910 shares)	10	—
WyoTech Acquisition Corporation (Education)	Debt Securities	12,588	12,588
	Preferred Stock (100 shares)	3,700	3,700
	Common Stock (99 shares)	100	44,100
<b>Total companies more than 25% owned</b>		<b>\$451,705</b>	<b>\$505,620</b>
<b>Companies 5% to 25% Owned</b>			
Aspen Pet Products, Inc. (Consumer Products)	Loans	\$ 14,576	\$ 14,576
	Preferred Stock (1,860 shares)	1,981	1,981
	Common Stock (1,400 shares)	140	140
Autania AG(1,3) (Industrial Products)	Debt Securities	4,762	4,762
	Common Stock (250,000 shares)	2,261	2,261
Colibri Holding Corporation (Consumer Products)	Loans	3,464	3,464
	Preferred Stock (237 shares)	237	237
	Common Stock (3,362 shares)	1,250	1,250
	Warrants	290	290
CorrFlex Graphics, LLC (Business Services)	Debt Securities	2,312	2,312
	Warrants	—	6,674
	Options	—	576
Csabai Canning Factory Rt(3) (Consumer Products)	Hungarian Quotas (9.2%)	700	—
CyberRep (Business Services)	Loan	1,109	1,109
	Debt Securities	14,209	14,209
	Warrants	660	3,310
The Debt Exchange Inc. (Business Services)	Preferred Stock (921,829 shares)	1,250	1,250
FTI Consulting, Inc.(1) (Business Services)	Warrants	—	510
Gibson Guitar Corporation (Consumer Products)	Debt Securities	17,175	17,175
	Warrants	525	2,325

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Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	December 31, 2001	
		Cost	Value
International Fiber Corporation (Industrial Products)	Debt Securities	\$ 22,257	\$ 22,257
	Common Stock (1,029,068 shares)	5,483	6,982
	Warrants	550	700
Liberty-Pittsburgh Systems, Inc. (Business Services)	Debt Securities	3,487	3,487
	Common Stock (123,929 shares)	142	142
Logic Bay Corporation (Business Services)	Preferred Stock (1,131,222 shares)	5,000	5,000
Magna Card, Inc.	Debt Securities	153	153

(Consumer Products)	Preferred Stock (1,875 shares)	94	94
	Common Stock (4,687 shares)	—	—
Master Plan, Inc.	Loan	1,204	1,204
(Business Services)	Common Stock (156 shares)	42	2,042
MortgageRamp.com, Inc.	Common Stock (772,000 shares)	3,860	3,860
(Business Services)			
Morton Grove	Loan	16,150	16,150
Pharmaceuticals, Inc.	Preferred Stock (106,947 shares)	5,000	9,000
(Consumer Products)			
Nobel Learning Communities, Inc.(1)	Debt Securities	9,656	9,656
(Education)	Preferred Stock (265,957 shares)	2,000	2,000
	Warrants	575	575
North American Archery, LLC	Loans	1,390	840
(Consumer Products)	Convertible Debentures	2,248	2,008
	Guaranty (\$270)	—	—
Packaging Advantage Corporation	Debt Securities	11,586	11,586
(Business Services)	Common Stock (200,000 shares)	2,000	2,000
	Warrants	963	963
Professional Paint, Inc.	Debt Securities	21,409	21,409
(Consumer Products)	Preferred Stock (15,000 shares)	17,215	17,215
	Common Stock (110,000 shares)	69	3,069
Progressive International Corporation	Debt Securities	3,958	3,958
(Consumer Products)	Preferred Stock (500 shares)	500	500
	Common Stock (197 shares)	13	13
	Warrants	—	—
Staffing Partners Holding Company, Inc.	Debt Securities	4,992	4,992
(Business Services)	Preferred Stock (414,600 shares)	2,073	2,073
	Common Stock (50,200 shares)	50	50
	Warrants	10	10
<b>Total companies 5% to 25% owned</b>		<b>\$211,030</b>	<b>\$232,399</b>

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(4) Non-registered investment company.

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Private Finance Portfolio Company		December 31, 2001	
(in thousands, except number of shares)	Investment(2)	Cost	Value
<b>Companies Less Than 5% Owned</b>			
Ability One Corporation	Loans	\$10,657	\$10,657
(Consumer Products)			
ACE Products, Inc.	Loans	16,875	16,875
(Industrial Products)			
Advantage Mayer, Inc.	Debt Securities	10,945	10,945
(Business Services)	Warrants	—	—

Allied Office Products, Inc. (Business Services)	Debt Securities	7,491	7,491
	Warrants	629	629
American Barbecue & Grill, Inc. (Retail)	Warrants	125	—
American Home Care Supply, LLC (Consumer Products)	Debt Securities	6,906	6,906
	Warrants	579	1,579
ASW Holding Corporation (Industrial Products)	Warrants	25	25
Aurora Communications, LLC (Broadcasting & Cable)	Loans	15,809	15,809
	Equity Interest	2,461	6,050
Avborne, Inc. (Business Services)	Debt Securities	12,750	6,375
	Warrants	1,180	—
Bakery Chef, Inc. (Consumer Products)	Loans	17,018	17,018
Blue Rhino Corporation(1) (Consumer Products)	Debt Securities	13,816	13,816
	Warrants	1,200	2,000
Border Foods, Inc. (Consumer Products)	Debt Securities	9,313	9,313
	Preferred Stock (50,919 shares)	2,000	2,000
	Warrants	665	665
Camden Partners Strategic Fund II, L.P. (4) (Private Equity Fund)	Limited Partnership Interest	1,295	1,295
CampGroup, LLC (Recreation)	Debt Securities	2,702	2,702
	Warrants	220	220
Candlewood Hotel Company(1) (Hospitality)	Preferred Stock (3,250 shares)	3,250	3,250
Celebrities, Inc. (Broadcasting & Cable)	Loan	244	244
	Warrants	12	550
Classic Vacation Group, Inc.(1) (Consumer Products)	Loan	6,399	6,399

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Private Finance Portfolio Company		December 31, 2001	
(in thousands, except number of shares)	Investment(2)	Cost	Value
Component Hardware Group, Inc. (Industrial Products)	Debt Securities	\$10,774	\$10,774
	Preferred Stock (18,000 shares)	1,800	1,800
	Common Stock (2,000 shares)	200	200
Convenience Corporation of America (Retail)	Debt Securities	8,355	2,738
	Preferred Stock (22,301 shares)	334	—
	Warrants	—	—
Cooper Natural Resources, Inc.	Debt Securities	1,750	1,750

(Industrial Products)	Preferred Stock (6,316 shares)	1,427	1,427
	Warrants	832	832
Coverall North America, Inc. (Business Services)	Loan	10,309	10,309
	Debt Securities	5,324	5,324
	Warrants	—	—
CPM Acquisition Corporation (Industrial Products)	Loan	9,604	9,604
CTT Holdings (Consumer Products)	Loan	1,388	1,388
Drilltec Patents & Technologies Company, Inc. (Industrial Products)	Loan	10,918	9,262
	Debt Securities	1,500	1,500
	Warrants	—	—
eCentury Capital Partners, L.P.(4) (Private Equity Fund)	Limited Partnership Interest	1,875	1,800
El Dorado Communications, Inc. (Broadcasting & Cable)	Loans	306	306
Elexis Beta GmbH(3) (Industrial Products)	Options	426	526
Eparfin S.A.(3) (Consumer Products)	Loan	29	29
E-Talk Corporation (Business Services)	Debt Securities	8,852	6,509
	Warrants	1,157	—
Ex Terra Credit Recovery, Inc. (Business Services)	Preferred Stock (500 shares)	568	318
	Common Stock (2,500 shares)	—	—
	Warrants	—	—
Executive Greetings, Inc. (Business Services)	Debt Securities	15,938	15,938
	Warrants	360	360
Fairchild Industrial Products Company (Industrial Products)	Debt Securities	5,872	5,872
	Warrants	280	2,378
Galaxy American Communications, LLC (Broadcasting & Cable)	Debt Securities	48,869	39,217
	Options	—	—
	Standby Letter of Credit (\$750)	—	—

(1) Public company.

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(3) Non-U.S. company.

(4) Non-registered investment company.

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Private Finance Portfolio Company		December 31, 2001	
(in thousands, except number of shares)	Investment(2)	Cost	Value
Garden Ridge Corporation (Retail)	Debt Securities	\$26,948	\$26,948
	Preferred Stock (1,130 shares)	1,130	1,130
	Common Stock (471 shares)	613	613
Ginsey Industries, Inc.	Loans	5,000	5,000

(Consumer Products)	Convertible Debentures Warrants	500 —	500 504
Global Communications, LLC (Business Services)	Loan Debt Securities Equity Interest Options	1,990 14,884 11,067 1,639	1,990 14,884 11,067 1,639
Grant Broadcasting Systems II (Broadcasting & Cable)	Warrants	87	5,976
Grant Television II LLC (Broadcasting & Cable)	Options	492	492
Grotech Partners, VI, L.P.(4) (Private Equity Fund)	Limited Partnership Interest	1,463	1,060
The Hartz Mountain Corporation (Consumer Products)	Debt Securities Common Stock (200,000 shares) Warrants	27,408 2,000 2,613	27,408 2,000 2,613
Hotelevision, Inc. (Broadcasting & Cable)	Preferred Stock (315,100 shares)	315	315
Icon International, Inc. (Business Services)	Common Stock (37,821 shares)	1,219	1,519
Impact Innovations Group, LLC (Business Services)	Debt Securities Warrants	6,598 1,674	6,598 1,674
Intellirisk Management Corporation (Business Services)	Loans	22,334	22,334
Interline Brands, Inc. (Business Services)	Debt Securities Warrants	32,839 3,169	32,839 3,169
iSolve Incorporated (Business Services)	Preferred Stock (14,853 shares) Common Stock (13,306 shares)	874 14	— —
Jakel, Inc. (Industrial Products)	Loan	22,291	22,291
JRI Industries, Inc. (Industrial Products)	Debt Securities Warrants	1,972 74	1,972 74
Julius Koch USA, Inc. (Industrial Products)	Debt Securities Warrants	1,066 259	1,066 7,000
Kirker Enterprises, Inc. (Industrial Products)	Warrants Equity Interest	348 4	3,501 4

(1) Public company.

(2) Common stock, preferred stock, warrants, options and equity interests are generally non-income producing and restricted.

(3) Non-U.S. company.

(4) Non-registered investment company.

The accompanying notes are an integral part of these consolidated financial statements.

Private Finance Portfolio Company		December 31, 2001	
(in thousands, except number of shares)	Investment(2)	Cost	Value
Kirkland's, Inc. (Retail)	Debt Securities	\$ 7,676	\$ 7,676
	Preferred Stock (917 shares)	412	412
	Warrants	96	96
Kyrus Corporation (Business Services)	Debt Securities	7,810	7,810
	Warrants	348	348
The Loewen Group, Inc.(1) (Consumer Services)	High-Yield Senior Secured Debt	15,150	12,440
Love Funding Corporation (Financial Services)	Preferred Stock (26,000 shares)	359	213
Matrics, Inc. (Business Services)	Preferred Stock (511,876 shares)	500	500
	Warrants	—	—
MedAssets.com, Inc. (Business Services)	Debt Securities	14,949	14,949
	Preferred Stock (260,417 shares)	2,049	2,049
	Warrants	136	136
Mid-Atlantic Venture Fund IV, L.P.(4) (Private Equity Fund)	Limited Partnership Interest	2,475	1,586
Midview Associates, L.P. (Housing)	Warrants	—	—
Most Confiserie GmbH & Co KG(3) (Consumer Products)	Loan	933	933
MVL Group, Inc. (Business Services)	Loan	1,856	1,856
	Debt Securities	14,806	14,806
	Warrants	643	643
	Guaranty (\$1,357)	—	—
NetCare, AG(3) (Business Services)	Loan	811	811
NETtel Communications, Inc. (Telecommunications)	Debt Securities and Receivables	11,334	4,334
Northeast Broadcasting Group, L.P. (Broadcasting & Cable)	Debt Securities	310	310
Novak Biddle Venture Partners III, L.P. (4) (Private Equity Fund)	Limited Partnership Interest	330	330
Nursefinders, Inc. (Business Services)	Debt Securities	11,341	11,341
	Warrants	900	1,500
Onyx Television GmbH(3) (Broadcasting & Cable)	Preferred Units (120,000 shares)	201	201

(1) Public company.

(2) Common stock, preferred stock, warrants, options and equity interests are generally non-income producing and restricted.

(3) Non-U.S. company.

(4) Non-registered investment company.

The accompanying notes are an integral part of these consolidated financial statements.

Private Finance Portfolio Company		December 31, 2001	
(in thousands, except number of shares)	Investment(2)	Cost	Value
Opinion Research Corporation(1) (Business Services)	Debt Securities	\$14,186	\$14,186
	Warrants	996	996
Oriental Trading Company, Inc. (Consumer Products)	Debt Securities	12,847	12,847
	Preferred Equity Interest	1,500	1,500
	Common Equity Interest	—	—
	Warrants	13	588
Outsource Partners, Inc. (Business Services)	Debt Securities	23,994	23,994
	Warrants	826	826
Pico Products, Inc. (Industrial Products)	Loan	1,406	1,406
Polaris Pool Systems, Inc. (Consumer Products)	Debt Securities	6,581	6,581
	Warrants	1,050	1,050
Powell Plant Farms, Inc. (Consumer Products)	Loan	16,993	16,993
Proeducation GmbH(3) (Education)	Loan	206	206
Prosperco Finanz Holding AG(3) (Financial Services)	Convertible Debentures	4,899	4,899
	Common Stock (1,528 shares)	956	956
	Warrants	—	—
Raytheon Aerospace, LLC (Business Services)	Debt Securities	5,051	5,051
	Equity Interest	—	—
Redox Brands, Inc. (Consumer Products)	Debt Securities	9,462	9,462
	Warrants	584	584
Schwinn Holdings Corporation (Consumer Products)	Debt Securities	10,195	1,835
Seasonal Expressions, Inc. (Consumer Products)	Preferred Stock (504 shares)	500	—
Simula, Inc.(1) (Industrial Products)	Loan	19,914	19,914
Soff-Cut Holdings, Inc. (Industrial Products)	Debt Securities	8,569	8,569
	Preferred Stock (300 shares)	300	300
	Common Stock (2,000 shares)	200	200
	Warrants	446	446
Southwest PCS, LLC (Telecommunications)	Loan	8,243	8,243
Startec Global Communications Corporation(1) (Telecommunications)	Loan	22,815	22,815
	Debt Securities	21,286	10,301
	Common Stock (258,064 shares)	3,000	—
	Warrants	—	—

(1) Public company.

(2) Common stock, preferred stock, warrants, options and equity interests are generally non-income producing and restricted.

(3) Non-U.S. company.

(4) Non-registered investment company.

The accompanying notes are an integral part of these consolidated financial statements.



Private Finance Portfolio Company		December 31, 2001	
(in thousands, except number of shares)	Investment(2)	Cost	Value
SunStates Refrigerated Services, Inc. (Warehouse Facilities)	Loans Debt Securities	\$ 6,062 2,445	\$ 4,573 877
Sydran Food Services II, L.P. (Retail)	Debt Securities Equity Interests Warrants	12,973 3,909	12,973 3,909
Tubbs Snowshoe Company, LLC (Consumer Products)	Debt Securities Equity Interests Warrants	3,913 500 54	3,913 500 54
United Pet Group, Inc. (Consumer Products)	Debt Securities Warrants	4,965 15	4,965 15
Updata Venture Partners, II, L.P.(4) (Private Equity Fund)	Limited Partnership Interest	2,300	3,865
Velocita, Inc.(1) (Telecommunications)	Debt Securities Warrants	11,677 3,540	11,677 3,540
Venturehouse Group, LLC(4) (Private Equity Fund)	Equity Interest	667	398
Walker Investment Fund II, LLLP(4) (Private Equity Fund)	Limited Partnership Interest	1,000	743
Warn Industries, Inc. (Consumer Products)	Debt Securities Warrants	18,624 1,429	18,624 3,129
Williams Brothers Lumber Company (Retail)	Warrants	24	322
Wilshire Restaurant Group, Inc. (Retail)	Debt Securities Warrants	15,106 735	15,106 735
Wilton Industries, Inc. (Consumer Products)	Loan	12,000	12,000
Woodstream Corporation (Consumer Products)	Loan Debt Securities Equity Interests Warrants	572 7,631 1,700 450	572 7,631 4,547 1,203
Total companies less than 5% owned		\$ 891,231	\$ 857,053
Total private finance (135 portfolio companies)		\$1,553,966	\$1,595,072

(1) Public company.

(2) Common stock, preferred stock, warrants, options and equity interests are generally non-income producing and restricted.

(3) Non-U.S. company.

(4) Non-registered investment company.

The accompanying notes are an integral part of these consolidated financial statements.

(in thousands, except number of loans)	Stated Interest	Face	December 31, 2001	
			Cost	Value
Commercial Real Estate Finance				
Commercial Mortgage-Backed Securities				
CMBS Bonds				
Mortgage Capital Funding, Series 1998-MC3	5.5%	\$ 54,491	\$ 26,888	\$ 26,888
Morgan Stanley Capital I, Series 1999-RM1	6.4%	51,046	21,462	21,462
COMM 1999-1	5.6%	74,879	35,636	35,636
Morgan Stanley Capital I, Series 1999-FNV1	6.1%	45,527	22,272	22,272
DLJ Commercial Mortgage Trust 1999-CG2	6.1%	96,432	44,732	44,732
Commercial Mortgage Acceptance Corp., Series 1999-C1	6.8%	34,856	16,304	16,304
LB Commercial Mortgage Trust, Series 1999-C2	6.7%	29,005	11,326	11,326
Chase Commercial Mortgage Securities Corp., Series 1999-2	6.5%	43,046	20,535	20,535
FUNB CMT, Series 1999-C4	6.5%	49,287	22,253	22,253
Heller Financial, HFCMC Series 2000 PH-1	6.8%	45,456	18,657	18,657
SBMS VII, Inc., Series 2000-NL1	7.2%	24,230	13,309	13,309
DLJ Commercial Mortgage Trust, Series 2000-CF1	7.0%	40,502	19,481	19,481
Deutsche Bank Alex. Brown, Series Comm 2000-C1	6.9%	41,084	19,418	19,418
LB-UBS Commercial Mortgage Trust, Series 2000-C4	6.9%	31,471	11,455	11,455
Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CK1	5.9%	58,786	29,050	29,050
JP Morgan-CIBC-Deutsche 2001	5.8%	60,889	29,584	29,584
Lehman Brothers-UBS Warburg 2001-C4	6.4%	65,130	32,326	32,326
SBMS VII, Inc., Series 2001-C1	6.1%	54,780	25,267	25,267
GE Capital Commercial Mortgage Securities Corp., Series 2001-2	6.1%	57,039	28,103	28,103
Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CKN5	5.2%	84,482	46,176	46,176
JP Morgan Chase Commercial Mortgage Securities Corp., Series 2001-C1	5.6%	55,432	24,075	24,075
SBMS VII, Inc., Series 2001-C2	6.2%	72,422	40,037	40,037
Total CMBS bonds		1,170,272	558,346	558,346
Collateralized Debt Obligations				
Crest 2001-1, Ltd.(3)		24,207	24,207	24,207
Total CMBS		\$1,194,479	\$582,553	\$582,553

	Interest Rate Ranges	Number of Loans	Cost	Value
<b>Commercial Mortgage Loans</b>				
	Up to 6.99%	7	\$ 3,404	\$ 5,100
	7.00%- 8.99%	30	34,583	36,589
	9.00%-10.99%	16	13,617	13,618
	11.00%-12.99%	14	11,977	11,979
	13.00%-14.99%	7	12,455	12,251
	15.00% and above	2	84	60
Total commercial mortgage loans		76	\$ 76,120	\$ 79,597
Residual Interest			\$ 70,179	\$ 69,879
Real Estate Owned			3,784	2,489
Total commercial real estate finance			\$ 732,636	\$ 734,518
Total portfolio			\$2,286,602	\$2,329,590

(3) Non-U.S. company.

The accompanying notes are an integral part of these consolidated financial statements.

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## **ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Information at June 30, 2002 and 2001 and for the three and six months ended June 30, 2002 and 2001 is unaudited)**

#### **Note 1. Organization**

Allied Capital Corporation, a Maryland corporation, is a closed-end management investment company that has elected to be regulated as a business development company ("BDC") under the Investment Company Act of 1940 ("1940 Act"). Allied Capital Corporation ("ACC") has a subsidiary that has also elected to be regulated as a BDC, Allied Investment Corporation ("Allied Investment"), which is licensed under the Small Business Investment Act of 1958 as a Small Business Investment Company ("SBIC"). In addition, ACC has a real estate investment trust subsidiary, Allied Capital REIT, Inc. ("Allied REIT"), and several subsidiaries which are single-member limited liability companies established primarily to hold real estate properties. In April 2001, ACC established a subsidiary, A.C. Corporation ("AC Corp"), which provides diligence and structuring services on private finance and commercial real estate transactions, as well as structuring, transaction, management and advisory services to the Company, its portfolio companies and other third parties.

Allied Capital Corporation and its subsidiaries, collectively, are hereinafter referred to as the "Company."

In accordance with specific rules prescribed for investment companies, subsidiaries hold investments on behalf of the Company or provide substantial services to the Company. Portfolio investments are held for purposes of deriving investment income and future capital gains. The Company consolidates the results of its subsidiaries for financial reporting purposes. The financial results of the Company's portfolio investments are not consolidated in the Company's financial statements.

The investment objective of the Company is to achieve current income and capital gains. In order to achieve this objective, the Company invests primarily in private companies in a variety of industries and non-investment grade commercial mortgage-backed securities ("CMBS").

#### **Note 2. Summary of Significant Accounting Policies**

##### ***Basis of Presentation***

The consolidated financial statements include the accounts of the Company and its subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation. Certain

reclassifications have been made to the 2001 balances to conform with the 2002 financial statement presentation.

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information. Accordingly, the interim financial information does not include all of the information and footnotes required by GAAP for complete consolidated financial statements. In the opinion of management, the unaudited consolidated financial statements of the Company included herein contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial position of the Company as of June 30, 2002 and December 31, 2001 and the results of operations for the three and six months ended June 30, 2002 and 2001, and changes in net assets and cash flows for the six months ended June 30, 2002 and 2001. The results of operations for the three and six months ended June 30, 2002 are not necessarily indicative of the operating results to be expected for the full year.

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## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

#### Note 2. Summary of Significant Accounting Policies, continued

The private finance portfolio is presented in three categories — companies more than 25% owned which represent portfolio companies where the Company directly or indirectly owns more than 25% of the outstanding voting securities of such portfolio company and, therefore, are deemed controlled by the Company under the 1940 Act; companies owned 5% to 25% which represent portfolio companies where the Company directly or indirectly owns 5% to 25% of the outstanding voting securities of such portfolio company or where the Company holds one or more seats on the portfolio company's board of directors and, therefore, are deemed to be an affiliated person under the 1940 Act; and companies less than 5% owned which represent portfolio companies where the Company directly or indirectly owns less than 5% of the outstanding voting securities of such portfolio company and where the Company has no other affiliations with such portfolio company. The interest and related portfolio income and net realized gains or losses from the commercial real estate finance portfolio and other sources are included in the companies less than 5% owned category on the consolidated statement of operations.

#### *Valuation of Portfolio Investments*

The Company, as a BDC, invests primarily in illiquid securities including debt and equity securities of private companies and non-investment grade CMBS. The Company's investments are generally subject to restrictions on resale and generally have no established trading market. The Company values substantially all of its investments at fair value as determined in good faith by the board of directors in accordance with the Company's valuation policy. The Company determines fair value to be the amount for which an investment could be exchanged in an orderly disposition over a reasonable period of time between willing parties other than in a forced or liquidation sale.

The Company's valuation policy considers the fact that no ready market exists for substantially all of the securities in which it invests. The Company's valuation policy is intended to provide a consistent basis for establishing the fair value of the portfolio. The Company will record unrealized depreciation on investments when it believes that an investment has become impaired, including where collection of a loan or realization of an equity security is doubtful. Conversely, the Company will record unrealized appreciation if it believes that the underlying portfolio company has appreciated in value and the Company's equity security has also appreciated in value, where appropriate. The value of investments in public securities are determined using quoted market prices discounted for restrictions on resale.

### ***Loans and Debt Securities***

For loans and debt securities, fair value generally approximates cost unless the borrower's enterprise value or overall financial condition or other factors lead to a determination of fair value at a different amount.

When the Company receives nominal cost warrants or free equity securities ("nominal cost equity"), the Company allocates its cost basis in its investment between its debt securities and its nominal cost equity at the time of origination. At that time, the original issue discount basis of the nominal cost equity is recorded by increasing the cost basis in the equity and decreasing the cost basis in the related debt securities.

Interest income is recorded on an accrual basis to the extent that such amounts are expected to be collected. For loans and debt securities with contractual payment-in-kind interest, which represents contractual interest accrued and added to the loan balance that generally becomes due at maturity,

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## **ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

#### **Note 2. Summary of Significant Accounting Policies, continued**

the Company will not accrue payment-in-kind interest if the portfolio company valuation indicates that the payment-in-kind interest is not collectible. Loans classified as Grade 4 or Grade 5 assets do not accrue interest. Loan origination fees, original issue discount and market discount are capitalized and then amortized into interest income using the effective interest method. Prepayment premiums are recorded on loans when received.

The weighted average yield on loans and debt securities is computed as the (a) annual stated interest rate earned plus the annual amortization of loan origination fees, original issue discount and market discount earned on accruing loans and debt securities, divided by (b) total loans and debt securities at value. The weighted average yield is computed as of the balance sheet date.

### ***Equity Securities***

The Company's equity interests in portfolio companies for which there is no liquid public market are valued at fair value based on the enterprise value of the portfolio company, which is determined using various factors, including cash flow from operations of the portfolio company and other pertinent factors such as recent offers to purchase a portfolio company's securities or other liquidation events. The determined fair values are generally discounted to account for restrictions on resale and minority control positions.

The value of the Company's equity interests in public companies for which market quotations are readily available is based upon the closing public market price on the balance sheet date. Securities that carry certain restrictions on sale are typically valued at a discount from the public market value of the security.

Dividend income is recorded on cumulative preferred equity securities on an accrual basis to the extent that such amounts are expected to be collected, and on common equity securities on the record date for private companies or on the ex-dividend date for publicly traded companies.

### ***Commercial Mortgage-Backed Securities ("CMBS")***

CMBS are carried at fair value, which is based upon a discounted cash flow model that utilizes prepayment and loss assumptions based upon historical experience and projected performance, economic factors and the characteristics of the underlying cash flow. The Company's assumption with regard to discount rate is based upon the yield of comparable securities. The Company recognizes income from the amortization of original issue discount using the effective interest method, using the anticipated yield over the projected life of the investment. Yields are revised when there are changes in estimates of future credit losses, actual losses incurred, or actual and estimated prepayment speeds. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the CMBS from the date the estimated yield is changed. The Company recognizes unrealized appreciation or depreciation on its CMBS, as comparable yields in the market change and/or whenever it determines that the value of its CMBS is less than the cost basis due to impairment in the underlying collateral pool.

### ***Residual Interest***

The Company values its residual interest from a previous securitization and recognizes income using the same accounting policies used for the CMBS. The residual interest is carried at fair value based on discounted estimated future cash flows. The Company recognizes income from the residual

**Note 2. Summary of Significant Accounting Policies, continued**

interest using the effective interest method. At each reporting date, the effective yield is recalculated and used to recognize income until the next reporting date.

***Net Realized and Unrealized Gains or Losses***

Realized gains or losses are measured by the difference between the net proceeds from the sale and the cost basis of the investment without regard to unrealized gains or losses previously recognized, and include investments charged off during the year, net of recoveries. Unrealized gains or losses reflect the change in portfolio investment values during the reporting period.

***Fee Income***

Fee income includes fees for diligence, structuring, transaction services, management services and investment advisory services rendered by the Company to portfolio companies and other third parties. Diligence, structuring and transaction services fees are generally recognized as income when services are rendered or when the related transactions are completed. Management and investment advisory services fees are generally recognized as income as the services are rendered.

***Deferred Financing Costs***

Financing costs are based on actual costs incurred in obtaining debt financing and are deferred and amortized as part of interest expense over the term of the related debt instrument.

***Derivative Financial Instruments***

The Company may or may not use derivative financial instruments to reduce interest rate risk. The Company has established policies and procedures for risk assessment and the approval, reporting and monitoring of derivative financial instrument activities. The Company does not hold or issue derivative financial instruments for trading purposes. All derivative financial instruments are recorded at fair value with changes in value reflected in net unrealized gains or losses during the reporting period.

***Cash and Cash Equivalents***

Cash and cash equivalents include cash in banks and all highly liquid investments with original maturities of three months or less.

***Dividends to Shareholders***

Dividends to shareholders are recorded on the record date.

***Stock Compensation Plans***

The Company applies the intrinsic value-based method of accounting prescribed by Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations to account for its stock compensation plans. Under this method, the

Company records compensation expense for awards of stock options to employees only if the market price of the stock on the grant date exceeds the amount the employee is required to pay to acquire the stock.

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## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

#### Note 2. Summary of Significant Accounting Policies, continued

##### *Federal and State Income Taxes*

The Company intends to comply with the requirements of the Internal Revenue Code ("Code") that are applicable to regulated investment companies ("RIC") and real estate investment trusts ("REIT"). The Company and its subsidiaries that qualify as a RIC or a REIT intend to annually distribute or retain through a deemed distribution all of their taxable income to shareholders; therefore, the Company has made no provision for income taxes for these entities. AC Corp is a corporation subject to federal and state income taxes and records a provision for income taxes as appropriate.

##### *Per Share Information*

Basic earnings per share is calculated using the weighted average number of shares outstanding for the period presented. Diluted earnings per share reflects the potential dilution that could occur if options to issue common stock were exercised into common stock. Earnings per share is computed after subtracting dividends on preferred shares.

##### *Use of Estimates in the Preparation of Financial Statements*

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from these estimates.

The consolidated financial statements include investments at value of \$2,380,969,000 and \$2,329,590,000 as of June 30 2002 and December 31, 2001, respectively, (93% and 95%, respectively, of total assets). Substantially all of these investments represent investments whose fair values have been determined by the board of directors in good faith in the absence of readily ascertainable market values. Because of the inherent uncertainty of valuation, the board of directors' estimated values may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

#### Note 3. Portfolio



**Private Finance**

At June 30, 2002 and December 31, 2001, the private finance portfolio consisted of the following:

(\$ in thousands)	2002			2001		
	Cost	Value	Yield	Cost	Value	Yield
Loans and debt securities	\$1,183,308	\$1,050,752	13.9%	\$1,169,673	\$1,107,890	14.8%
Equity interests	397,704	584,507		384,293	487,182	
Total	<u>\$1,581,012</u>	<u>\$1,635,259</u>		<u>\$1,553,966</u>	<u>\$1,595,072</u>	

Private finance investment activity principally involves providing financing through privately negotiated long-term debt and equity investments. Private finance investments are generally structured as loans and debt securities that carry a relatively high fixed rate of interest, which may be combined with equity features, such as conversion privileges, or warrants or options to purchase a portion of the portfolio company's equity at a pre-determined strike price, which is generally a nominal price for warrants or options in a private company. Private finance investments are generally issued by

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)****Note 3. Portfolio, continued**

privately-owned companies and are generally illiquid and subject to restrictions on resale or transferability.

Loans and debt securities generally have a maturity of five to ten years, with interest-only payments in the early years and payments of both principal and interest in the later years, although debt maturities and principal amortization schedules vary. At June 30, 2002 and December 31, 2001, approximately 97% and 98%, respectively, of the Company's private finance loan portfolio was composed of fixed interest rate loans.

Equity interests consist primarily of securities issued by privately-owned companies and may be subject to restrictions on their resale or may be otherwise illiquid. Equity securities generally do not produce a current return, but are held in anticipation of investment appreciation and ultimate gain on sale.

At June 30, 2002 and December 31, 2001, the Company had an investment at value totaling \$251,920,000 and \$227,449,000, respectively, in Business Loan Express, Inc. ("BLX"), a small

business lender that participates in the SBA Section 7(a) Guaranteed Loan Program. The Company owns 94.9% of BLX's common stock. As the controlling shareholder of BLX, the Company has provided an unconditional guaranty to the BLX credit facility lenders in an amount up to 50% of the total obligations (consisting of principal, accrued interest and other fees) on BLX's 3-year unsecured revolving credit facility for \$124,000,000. The amount guaranteed by the Company at June 30, 2002 was \$48,100,000. This guaranty can be called by the lenders only in the event of a default by BLX. BLX was in compliance with the terms of its credit facility at June 30, 2002. In consideration for providing this guaranty, BLX will pay the Company an annual guaranty fee of approximately \$3,100,000 in 2002. BLX is headquartered in New York, NY. The Company has also provided two standby letters of credit in connection with two term securitization transactions completed by BLX in the second quarter of 2002 totaling \$10,550,000.

At June 30, 2002 and December 31, 2001, the Company had an investment in The Hillman Companies, Inc. (formerly SunSource, Inc.) totaling \$131,012,000 and \$97,227,000 at value, respectively. The Company owns 93.2% of Hillman's common stock. Hillman is a leading manufacturer of key making equipment and distributor of key blanks, fasteners, signage and other small hardware components and operates in multiple channels of the retail marketplace such as hardware stores, national and regional home centers and mass merchants. Hillman's primary operations are located in Cincinnati, Ohio.

At June 30, 2002 and December 31, 2001, the Company had an investment in WyoTech Acquisition Corporation at value totaling \$77,008,000 and \$60,388,000, respectively. The Company owned 91.35% of WyoTech's common stock. WyoTech is a proprietary trade school and its primary operations are in Laramie, Wyoming. WyoTech was sold on July 1, 2002. See Note 13 for the subsequent event.

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

#### Note 3. Portfolio, continued

At June 30, 2002 and December 31, 2001, Grade 4 and 5 loans and debt securities that were not accruing interest at value were as follows:

(in thousands)	2002	2001
Companies more than 25% owned	\$ 721	\$ 930
Companies 5% to 25% owned	899	2,848
Companies less than 5% owned	103,562	89,966
	<u>\$105,182</u>	<u>\$93,744</u>

Included in Grade 4 and 5 loans and debt securities not accruing interest were assets valued at

\$8.9 million at June 30, 2002 and December 31, 2001 that represented receivables related to companies in liquidation. In addition to Grade 4 and 5 assets that are in workout, we may not accrue interest on loans to companies that are more than 50% owned by the Company if such companies are in need of additional capital and, therefore, the Company may defer current debt service. Loans and debt securities to such companies totaled \$61,331,000 at value at June 30, 2002.

The industry and geographic compositions of the private finance portfolio at value at June 30, 2002 and December 31, 2001 were as follows:

	2002	2001
<b>Industry</b>		
Consumer products	30%	28%
Business services	24	22
Financial services	16	15
Industrial products	10	10
Retail	5	5
Education	5	5
Telecommunications	3	4
Broadcasting & cable	2	4
Other	5	7
	—	—
Total	100%	100%
	—	—
<b>Geographic Region</b>		
Mid-Atlantic	42%	43%
West	20	19
Midwest	17	17
Southeast	14	14
Northeast	6	5
International	1	2
	—	—
Total	100%	100%
	—	—

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

#### Note 3. Portfolio, continued

##### *Commercial Real Estate Finance*

At June 30, 2002 and December 31, 2001, the commercial real estate finance portfolio consisted of the following:

(\$ in thousands)	2002			2001		
	Cost	Value	Yield	Cost	Value	Yield
CMBS	\$589,558	\$613,423	14.8%	\$582,553	\$582,553	14.8%
Loans	61,890	62,001	7.9%	76,120	79,597	7.7%
Residual interest	69,341	69,042	9.3%	70,179	69,879	9.4%
Real estate owned	3,451	1,244		3,784	2,489	
Total	<u>\$724,240</u>	<u>\$745,710</u>		<u>\$732,636</u>	<u>\$734,518</u>	

**CMBS**

At June 30, 2002 and December 31, 2001, the CMBS portfolio consisted of the following:

(in thousands)	2002			2001		
	Cost	Value	Yield	Cost	Value	Yield
CMBS bonds	\$537,025	\$560,890	14.6%	\$558,346	\$558,346	14.7%
Collateralized debt obligations	52,533	52,533	17.2%	24,207	24,207	16.9%
Total	<u>\$589,558</u>	<u>\$613,423</u>		<u>\$582,553</u>	<u>\$582,553</u>	

**CMBS Bonds.** At June 30, 2002 and December 31, 2001, the CMBS bonds, which were purchased from the original issuer, consisted of the following:

(\$ in thousands)	2002	2001
Face	\$1,181,989	\$1,170,272
Original issue discount	(644,964)	(611,926)
Cost	<u>\$ 537,025</u>	<u>\$ 558,346</u>
Value	<u>\$ 560,890</u>	<u>\$ 558,346</u>
Yield	14.6%	14.7%

The non-investment grade and unrated tranches of the CMBS bonds in which the Company invests are junior in priority for payment of interest and principal to the more senior tranches of the related CMBS bond issuance. Cash flow from the underlying mortgages generally is allocated first to the senior tranches, with the most senior tranches having a priority right to the cash flow. Then, any remaining cash flow is allocated, generally, among the other tranches in order of their relative seniority. To the extent there are defaults and unrecoverable losses on the underlying mortgages resulting in reduced cash flows, the Company's most subordinate tranche will bear this loss first. At June 30, 2002, the Company's CMBS bonds were subordinate to 92% to 97% of the tranches of bonds issued in various CMBS transactions. Given that the non-investment grade CMBS bonds in which the Company invests are junior in priority for payment of principal, the Company invests in these CMBS bonds at an approximate discount of 50% from the face amount of the bonds.

# **ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

## **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

### **Note 3. Portfolio, continued**

The underlying rating classes of the CMBS bonds at value at June 30, 2002 and December 31, 2001 were as follows:

(\$ in thousands)	2002		2001	
	Value	Percentage of Total	Value	Percentage of Total
BB+	\$ 28,668	5.1%	\$ 24,785	4.4%
BB	40,701	7.3	69,404	12.4
BB-	33,452	6.0	67,460	12.1
B+	123,056	21.9	103,560	18.6
B	158,035	28.2	131,362	23.5
B-	79,664	14.2	73,572	13.2
CCC	9,119	1.6	8,893	1.6
Unrated	88,195	15.7	79,310	14.2
Total	<u>\$560,890</u>	<u>100.0%</u>	<u>\$558,346</u>	<u>100.0%</u>

At June 30, 2002 and December 31, 2001, the underlying pools of mortgage loans that are collateral for our CMBS bonds consisted of approximately 4,100 and 3,800 commercial mortgage loans with a total outstanding principal balance of \$22.9 billion and \$20.5 billion, respectively. At June 30, 2002 and December 31, 2001, 0.75% and 0.52%, respectively, of the mortgage loans in the underlying collateral pool for the Company's CMBS bonds were over 30 days delinquent or were classified as real estate owned. The property types and the geographic composition of the mortgage loans in the underlying collateral pool calculated using the outstanding principal balance at June 30, 2002 and December 31, 2001 were as follows:

Property Type	2002	2001
Retail	31%	31%
Housing	27	27
Office	21	22
Hospitality	7	7
Other	14	13
Total	<u>100%</u>	<u>100%</u>

**Geographic Region**

West	31%	32%
Mid-Atlantic	25	24
Midwest	22	21
Southeast	17	17
Northeast	5	6
Total	100%	100%

The Company's yield on its CMBS bonds is based upon a number of assumptions that are subject to certain business and economic uncertainties and contingencies. Examples include the timing and magnitude of credit losses on the mortgage loans underlying the CMBS that are a result of the general condition of the real estate market (including competition for tenants and their related credit quality) and changes in market rental rates. The initial yield on each CMBS bond has been computed assuming an approximate 1% loss rate on its entire underlying collateral mortgage pool, with the estimated losses being assumed to occur in three equal installments in years three, six and nine. As each CMBS bond ages, the amount of losses and the expected timing of recognition of such

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)****Note 3. Portfolio, continued**

losses will be updated, and the respective yield will be adjusted as necessary. As these uncertainties and contingencies are difficult to predict and are subject to future events which may alter these assumptions, no assurance can be given that the anticipated yields to maturity will be achieved.

**Collateralized Debt Obligations.** At June 30, 2002, the Company owned preferred shares in three collateralized debt obligations ("CDOs") secured by investment grade unsecured debt issued by various real estate investment trusts ("REITs") and investment and non-investment grade CMBS bonds. The investment grade REIT debt collateral consists of \$852,826,000 issued by 39 REITs. The investment grade CMBS collateral consisted of bonds with a face amount of \$402,142,000 issued in 26 separate CMBS transactions. The non-investment grade CMBS collateral consists of BB+, BB and BB- CMBS bonds with a face amount of \$405,032,000 that were issued in 30 separate CMBS transactions ("CMBS Collateral"). Included in the CMBS Collateral for the CDOs are \$393,832,000 of CMBS bonds that are senior in priority of repayment to certain lower rated CMBS bonds held by the Company, which were issued in 22 separate CMBS transactions. The preferred shares are junior in priority for payment of principal to the more senior tranches of debt issued by the CDOs. To the extent there are defaults and unrecoverable losses on the underlying collateral resulting in reduced cash flows, the preferred shares will bear this loss first. At June 30, 2002, the Company's preferred shares in the CDOs were subordinate to approximately 95% of the more senior tranches of debt issued by the CDOs. The yield on the CDOs at June 30, 2002 and

December 31, 2001 was 17.2% and 16.9%, respectively.

The Company acts as the directing certificate holder for the CMBS bonds and as the disposition consultant with respect to two of the CDOs, which allows the Company to approve disposition plans for individual collateral securities. For these services with respect to the CDOs, the Company collects annual fees based on the outstanding collateral pool balance, and for the six months ended June 30, 2002, this fee totaled \$160,000.

### ***Loans***

The commercial mortgage loan portfolio contains loans that were originated by the Company or were purchased from third-party sellers.

At June 30, 2002 and December 31, 2001, approximately 75% and 25% and 76% and 24%, of the Company's commercial mortgage loan portfolio was composed of fixed and adjustable interest rate loans, respectively. As of June 30, 2002 and December 31, 2001, workout loans, or those loans in Grade 4 and 5, with a value of \$15,860,000 and \$15,241,000, respectively, were not accruing interest.

The property types and the geographic composition securing the commercial mortgage loan portfolio at value at June 30, 2002 and December 31, 2001 were as follows:

	<u>2002</u>	<u>2001</u>
<b>Property Type</b>		
Office	28%	34%
Hospitality	28	25
Retail	24	21
Recreation	3	4
Other	17	16
	<u>      </u>	<u>      </u>
Total	100%	100%
	<u>      </u>	<u>      </u>

## **ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

#### **Note 3. Portfolio, continued**

<b>Geographic Region</b>		
Southeast	40%	36%
Mid-Atlantic	17	23
West	23	20
Midwest	13	16
Northeast	7	5
	<u>      </u>	<u>      </u>
Total	100%	100%
	<u>      </u>	<u>      </u>

**Residual Interest**

At June 30, 2002 and December 31, 2001, the residual interest consisted of the following:

	2002		2001	
	Cost	Value	Cost	Value
(in thousands)				
Residual interest	\$68,853	\$68,853	\$68,853	\$68,853
Residual interest spread	488	189	1,326	1,026
Total	\$69,341	\$69,042	\$70,179	\$69,879

The residual interest primarily consists of a retained interest totaling \$68,853,000 from a 1998 asset securitization whereby bonds were sold in three classes rated AAA, AA and A. The residual interest represents a right to cash flows from the underlying collateral pool of loans after these senior bond obligations are satisfied. At June 30, 2002, two classes of bonds rated AAA and AA+ are outstanding, for total bonds outstanding of \$29,600,000. The Company has the right to call the bonds when the outstanding bond balance is less than \$23,900,000. Once the bonds are fully repaid, either through the cash flows from the securitized loans or due to the Company calling the bonds, the remaining loans in the trust will be returned to the Company as payment on the residual interest.

The Company sold \$295 million of loans, and received cash proceeds, net of costs, of approximately \$223 million in January 1998. The Company retained a trust certificate for its residual interest in a loan pool sold, and will receive interest income from this residual interest as well as the residual interest spread ("Residual") from the interest earned on the loans sold less the interest paid on the bonds over the life of the bonds. As of June 30, 2002 and December 31, 2001, the mortgage loan pool had an approximate weighted average stated interest rate of 9.3%. The outstanding bond classes sold had an aggregate weighted average interest rate of 6.7% and 6.6% as of June 30, 2002 and December 31, 2001, respectively.

The Company uses a discounted cash flow methodology for determining the value of its retained Residual. In determining the cash flow of the Residual, the Company assumes a prepayment speed of 15% after the applicable prepayment lockout period and credit losses of 1% or approximately \$1.1 million of the total principal balance of the underlying collateral throughout the life of the collateral. These assumptions result in an expected weighted average life of the bonds of 0.5 years. The value of the resulting Residual cash flows is then determined by applying a discount rate of 9% which, in the Company's view, is commensurate with the market risk of comparable assets.

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**



## Note 4. Debt

The Company records debt at cost. At June 30, 2002 and December 31, 2001, the Company had the following debt:

	2002		2001	
	Facility Amount	Amount Drawn	Facility Amount	Amount Drawn
(in thousands)				
Notes payable and debentures:				
Unsecured long-term notes payable	\$ 694,000	\$ 694,000	\$ 694,000	\$ 694,000
SBA debentures	101,800	94,500	101,800	94,500
Auction rate reset note	75,000	75,000	81,856	81,856
OPIC loan	5,700	5,700	5,700	5,700
Total notes payable and debentures	876,500	869,200	883,356	876,056
Revolving line of credit	527,500	139,750	497,500	144,750
Total	<u>\$1,404,000</u>	<u>\$1,008,950</u>	<u>\$1,380,856</u>	<u>\$1,020,806</u>

### Notes Payable and Debentures

**Unsecured Long-Term Notes Payable.** The Company issued unsecured long-term notes to private institutional investors. The notes require semi-annual interest payments until maturity and have original terms of five or seven years. At June 30, 2002, the notes had remaining maturities of one to four years. The weighted average fixed interest rate on the notes was 7.6% at June 30, 2002 and December 31, 2001. The notes may be prepaid in whole or in part, together with an interest premium, as stipulated in the note agreement.

**SBA Debentures.** At June 30, 2002 and December 31, 2001, the Company had debentures payable to the SBA with terms of ten years and at fixed interest rates ranging from 5.9% to 8.2% and 2.4% to 8.2%, respectively. At June 30, 2002, the debentures had remaining maturities of three to ten years. The weighted average interest rate was 7.0% and 6.7% at June 30, 2002 and December 31, 2001, respectively. The debentures require semi-annual interest-only payments with all principal due upon maturity. The SBA debentures are subject to prepayment penalties if paid prior to maturity. At June 30, 2002, the Company has a commitment from the SBA to borrow up to an additional \$7,300,000 above the amount outstanding. The commitment expires on September 30, 2005.

**Auction Rate Reset Note.** The Company has an Auction Rate Reset Senior Note Series A that matures on December 2, 2002, and bears interest at the three-month London Interbank Offered Rate ("LIBOR") plus 1.75%, which adjusts quarterly. Interest is due quarterly and the Company, at its option, may pay or defer such interest payments. The amount outstanding on the note will increase as interest due is deferred. Deferred interest may be repaid at any time without penalties.

As a means to repay the note, the Company has entered into an agreement with the placement agent of this note to serve as the placement agent on a future issuance of \$75.0 million of debt, equity or other securities in one or more public or private transactions. Alternatively, the Company may repay the note in cash without conducting a capital raise. If the Company chooses to pay in

cash without conducting a capital raise, the Company will incur additional expense of approximately \$2,063,000.

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

#### Note 4. Debt, continued

Scheduled future maturities of notes payable and debentures at June 30, 2002, are as follows:

Year	Amount Maturing (in thousands)
2002	\$ 75,000
2003	140,000
2004	221,000
2005	179,000
2006	180,700
Thereafter	73,500
Total	<u>\$869,200</u>

#### *Revolving Line of Credit*

The Company has an unsecured revolving line of credit for \$527,500,000. The facility may be expanded up to \$600,000,000 at the Company's option. The facility bears interest at a rate equal to (i) the one-month LIBOR plus 1.25% or (ii) the higher of (a) the Bank of America, N.A. prime rate or (b) the Federal Funds rate plus 0.50%. The interest rate adjusts at the beginning of each new interest period, usually every thirty days. The interest rates were 4.1% and 3.2% at June 30, 2002 and December 31, 2001, respectively, and the facility requires an annual commitment fee equal to 0.25% of the committed amount. The line expires in August 2003, and may be extended under substantially similar terms for one additional year at the Company's sole option. The line of credit requires monthly interest payments and all principal is due upon its expiration.

The average debt outstanding on the revolving line of credit was \$67,710,000 and \$106,338,000 for the six months ended June 30, 2002 and for the year ended December 31, 2001, respectively. The maximum amount borrowed under this facility and the weighted average interest rate for the six months ended June 30, 2002 and for the year ended December 31, 2001, were \$145,250,000 and \$213,500,000, and 3.2% and 5.4%, respectively.

The Company has various financial and operating covenants required by the revolving line of credit and the notes payable and debentures. These covenants require the Company to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. The Company's credit facilities limit its ability to declare dividends if the Company defaults under certain provisions. As of June 30, 2002, the Company was in compliance with these covenants.

**Note 5. Preferred Stock**

Allied Investment has outstanding a total of 60,000 shares of \$100 par value, 3% cumulative preferred stock and 10,000 shares of \$100 par value, 4% redeemable cumulative preferred stock issued to the SBA pursuant to Section 303(c) of the Small Business Investment Act of 1958, as amended. The 3% cumulative preferred stock does not have a required redemption date. Allied Investment has the option to redeem in whole or in part the preferred stock by paying the SBA the par value of such securities and any dividends accumulated and unpaid to the date of redemption. The 4% redeemable cumulative preferred stock has a required redemption date in June 2005.

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)****Note 6. Shareholders' Equity**

Sales of common stock for the six months ended June 30, 2002, and the year ended December 31, 2001 were as follows:

	2002	2001
(in thousands)		
Number of common shares	1,946	13,286
Gross proceeds	\$51,800	\$301,539
Less costs including underwriting fees	(1,880)	(14,651)
Net proceeds	<u>\$49,920</u>	<u>\$286,888</u>

In addition, the Company issued 204,855 shares of common stock with a value of \$5,157,000 to acquire one portfolio investment in a stock-for-stock exchange during 2001.

The Company has a dividend reinvestment plan, whereby the Company may buy shares of its common stock in the open market or issue new shares in order to satisfy dividend reinvestment requests. If the Company issues new shares, the issue price is equal to the average of the closing sale prices reported for the Company's common stock for the five consecutive days immediately prior to the dividend payment date.

Dividend reinvestment plan activity for the six months ended June 30, 2002 and for the year ended December 31, 2001 was as follows:

	2002	2001
(in thousands, except per share amounts)		
Shares issued	128	271
Average price per share	\$24.34	\$23.32

**Note 7. Earnings Per Common Share**

Earnings per common share for the three and six months ended June 30, 2002 and 2001 were as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2002	2001	2002	2001
(in thousands, except per share amounts)				
Net increase in net assets resulting from operations	\$ 73,454	\$46,106	\$129,415	\$98,134
Less preferred stock dividends	(55)	(55)	(110)	(110)
Income available to common shareholders	\$ 73,399	\$46,051	\$129,305	\$98,024
Basic shares outstanding	101,660	89,356	100,822	87,441
Dilutive options outstanding to officers	1,780	1,492	2,078	1,525
Diluted shares outstanding	103,440	90,848	102,900	88,966
Basic earnings per common share	\$ 0.72	\$ 0.52	\$ 1.28	\$ 1.12
Diluted earnings per common share	\$ 0.71	\$ 0.51	\$ 1.26	\$ 1.10

**Note 8. Dividends and Distributions**

The Company's Board of Directors declared and the Company paid dividends of \$0.53 and \$0.55 per common share for the first and second quarters of 2002, respectively. The dividends totaled \$56,223,000 and \$109,482,000 for the three and six months ended June 30, 2002, respectively. The

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)****Note 8. Dividends and Distributions, continued**

Company's Board of Directors also declared a dividend of \$0.56 per common share for the third quarter of 2002.

**Note 9. Supplemental Disclosure of Cash Flow Information**

For the six months ended June 30, 2002 and 2001, the Company paid \$34,055,000, and \$31,916,000, respectively, for interest. For the six months ended June 30, 2002 and 2001, the Company's non-cash financing activities totaled \$5,498,000 and \$7,569,000, respectively, and

includes stock option exercises and dividend reinvestment.

### Note 10. Hedging Activities

The Company invests in BB+, BB and BB- CMBS bonds, which are purchased at prices that are based on the 10-year Treasury rate. The Company has entered into transactions with two financial institutions to hedge against movement in Treasury rates on certain of these CMBS bonds. These transactions involved the Company receiving the proceeds from the sale of the borrowed Treasury securities, with the obligation to replenish the borrowed Treasury securities at a later date based on the then current market price. Borrowed Treasury securities as of June 30, 2002 and December 31, 2001 consisted of the following:

(in thousands) Description of Issue	June 30, 2002		December 31, 2001	
	Cost	Value	Cost	Value
10-year Treasury, due August 2011	\$ 2,074	\$ 2,008	\$19,175	\$17,989
10-year Treasury, due August 2011	1,010	1,040	5,693	5,656
10-year Treasury, due August 2011	7,585	7,917	23,636	23,618
5-year Treasury, due February 2006	5,590	5,746	—	—
10-year Treasury, due August 2011	19,404	19,903	—	—
10-year Treasury, due February 2012	2,624	2,665	—	—
10-year Treasury, due February 2012	25,351	26,445	—	—
10-year Treasury, due February 2012	18,990	19,065	—	—
	<u>\$82,628</u>	<u>\$84,789</u>	<u>\$48,504</u>	<u>\$47,263</u>

Obligations to replenish borrowed Treasury securities as of June 30, 2002 and December 31, 2001 were \$84,789,000 and \$47,263,000, respectively, and are recorded as other liabilities. As of June 30, 2002, the total obligations on the hedge had increased since the original sale date due to changes in the yield on the borrowed Treasury securities, resulting in unrealized depreciation on the obligations of \$2,161,000. The net proceeds related to the sales of the borrowed Treasury securities of \$82,628,000 and \$48,504,000 have been recorded as an other asset at June 30, 2002 and December 31, 2001, respectively.

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

### Note 11. Financial Highlights

	At and for the Six Months Ended June 30,		At and for the Years Ended December 31,				
	2002(5)	2001(5)	2001	2000	1999	1998	1997
<b>Per Common Share Data</b>							
Net asset value, beginning of period	\$ 13.57	\$ 12.11	\$ 12.11	\$ 10.20	\$ 8.79	\$ 8.07	\$ 8.34
Net investment income before income tax benefit (expense) and net realized and unrealized gains(1)	0.94	0.92	1.92	1.53	1.18	1.06	0.94
Income tax benefit (expense)(1)	—	—	0.01	—	—	(0.01)	(0.03)
Net realized and unrealized gains(1)	0.32	0.18	0.23	0.41	0.46	0.45	0.36
Minority interests(1)	—	—	—	—	—	—	(0.03)
Net increase in net assets resulting from operations	1.26	1.10	2.16	1.94	1.64	1.50	1.24
Net decrease in net assets from shareholder distributions(2)	(1.08)	(0.99)	(2.01)	(1.82)	(1.60)	(1.43)	(1.71)
Net increase in net assets from capital share transactions	0.27	0.57	1.31	1.79	1.37	0.65	0.20
Net asset value, end of period	\$ 14.02	\$ 12.79	\$ 13.57	\$ 12.11	\$ 10.20	\$ 8.79	\$ 8.07
Market value, end of period	\$ 22.65	\$ 23.15	\$ 26.00	\$ 20.88	\$ 18.31	\$ 17.31	\$ 22.25
Total return	(9.18)%	15.56%	35.43%	25.47%	14.99%	(15.74)%	77.76%
<b>Ratios and Supplemental Data (\$ and shares in thousands, except per share amounts)</b>							
Ending net assets	\$1,434,453	\$1,171,661	\$1,352,123	\$1,029,692	\$667,513	\$491,358	\$420,060
Common shares outstanding at end of period(3)	102,296	91,578	99,607	85,057	65,414	55,919	52,047
Diluted weighted average shares outstanding	102,900	88,966	93,003	73,472	60,044	51,974	49,251
Employee and administrative expenses/ average net assets	1.74%	1.85%	3.80%	4.98%	6.25%	7.09%	4.66%
Total expenses/average net assets(4)	4.26%	4.79%	9.31%	11.88%	12.44%	11.86%	12.43%
Net investment income/ average net assets(4)	6.94%	7.54%	15.15%	13.55%	12.61%	12.72%	11.15%
Portfolio turnover rate	8.33%	6.27%	10.04%	28.92%	34.19%	63.53%	42.72%
Average debt outstanding	\$ 940,357	\$ 812,500	\$ 847,121	\$ 707,400	\$461,500	\$261,300	\$336,800
Average debt per share	\$ 9.14	\$ 9.13	\$ 9.11	\$ 9.63	\$ 7.69	\$ 5.03	\$ 6.84

Average cost per share \$ 0.17 \$ 0.15 \$ 0.11 \$ 0.05 \$ 0.05 \$ 0.05 \$ 0.05

- (1) Based on diluted weighted average number of shares outstanding for the period.
- (2) For the year ended December 31, 1997, shareholder distributions include \$0.51 of merger-related dividends.
- (3) Excludes 234,977, 516,779 and 810,456 common shares held in the deferred compensation trust at or for the years ended December 31, 2000, 1999, and 1998, respectively.
- (4) For the purpose of calculating the ratios, total expenses and net investment income for the year ended December 31, 1997 exclude merger expenses of \$5,159,000.
- (5) The results for the six months ended June 30, 2002 and 2001, respectively, are not necessarily indicative of the operating results to be expected for the full year.

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## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

#### Note 12. Litigation

As of August 13, 2002, the Company is aware of seven class action lawsuits that have been filed in the United States District Court for the Southern District of New York against it, certain of its directors and officers and its former independent auditors, Arthur Andersen LLP, with respect to alleged violations of the securities laws. All of the actions essentially duplicate one another, pleading essentially the same allegations. The complaints filed in the lawsuits allege violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, specifically alleging, among other things, that the Company misstated the value of certain portfolio investments in its financial statements, which allegedly resulted in the purchase of its common stock by purported class members at artificially inflated prices. Several of the complaints also allege state law claims for common law fraud. The lawsuits seek compensatory and other damages, and costs and expenses associated with the litigation. The Company believes that each of the lawsuits is without merit, and it intends to defend each of these lawsuits vigorously. While the Company does not expect these matters to materially affect its financial condition or results of operations, there can be no assurance of any particular outcome.

The Company also is party to certain other lawsuits in the normal course of business. While the outcome of these legal proceedings cannot at this time be predicted with certainty, the Company does not expect that these proceedings will have a material effect upon its financial condition or results of operations.

#### Note 13. Subsequent Events

On July 1, 2002, the Company completed the sale of WyoTech Acquisition Corporation for approximately \$84.4 million in cash. The Company's total cash proceeds from the sale of WyoTech, including the repayment of debt and preferred stock and the sale of our 91% common

equity ownership, were approximately \$77.0 million, resulting in a realized gain of \$60.6 million in the third quarter of 2002 on the transaction. The sale of WyoTech is subject to post-closing working capital adjustments, if any, and customary indemnification provisions. Total interest and related portfolio income earned from WyoTech for the three months ended June 30, 2002 was \$1.8 million, which will no longer occur due to the sale of the investment on July 1, 2002.

On July 31, 2002, the Company completed the sale of \$82.7 million of CMBS, which resulted in a realized gain of approximately \$12 million. The bonds sold had an effective yield of 12%. Additionally, the Company reversed previously recorded net unrealized appreciation of approximately \$5 million related to these bonds.

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### **Independent Accountants' Review Report**

The Board of Directors and Shareholders  
Allied Capital Corporation and Subsidiaries:

We have reviewed the accompanying consolidated balance sheet of Allied Capital Corporation and subsidiaries, including the consolidated statement of investments, as of June 30, 2002, and the related consolidated statements of operations for the three- and six-month periods ended June 30, 2002, changes in net assets and cash flows for the six-month period ended June 30, 2002, and financial highlights (included in Note 11) for the six-month period ended June 30, 2002. These consolidated financial statements and financial highlights are the responsibility of the Company's management.

We conducted our review in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures to financial data and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with auditing standards generally accepted in the United States of America, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the consolidated financial statements and financial highlights referred to above for them to be in conformity with accounting principles generally accepted in the United States of America.

The consolidated balance sheet of Allied Capital Corporation and subsidiaries, including the statement of investments, as of December 31, 2001, and financial highlights (included in note 11) for the year then ended, were audited by other auditors whose report dated February 20, 2002 expressed an unqualified opinion on those statements.

/s/ KPMG LLP

Washington, D.C.



July 22, 2002, except as to notes 12 and 13 which are as of August 13, 2002 and July 31, 2002, respectively

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**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*The following analysis of the financial condition and results of operations of the Company should be read in conjunction with the Company's Consolidated Financial Statements and the Notes thereto included herein and in the Company's annual report on Form 10-K for the year ended December 31, 2001.*

*Financial or other information presented for private finance portfolio companies has been obtained from the portfolio company, and the financial information presented may represent unaudited, projected or pro forma financial information, and therefore may not be indicative of actual results. In addition, the private equity industry uses financial measures such as EBITDA or EBITDAM (Earnings Before Interest, Taxes, Depreciation, Amortization and, in some instances, Management fees) in order to assess a portfolio company's financial performance and to value a portfolio company. EBITDA and EBITDAM are not intended to represent cash flow from operations as defined by accounting principles generally accepted in the United States of America and such information should not be considered as an alternative to net income, cash flow from operations or any other measure of performance prescribed by accounting principles generally accepted in the United States of America.*

**OVERVIEW**

We are a business development company that provides long-term debt and equity investment capital to support the expansion of companies in a variety of industries. Our lending and investment activity is generally focused in private finance and commercial real estate finance, primarily in non-investment grade commercial mortgage-backed securities, which we refer to as CMBS. Our private finance activity principally involves providing financing through privately negotiated long-term debt and equity investment capital. Our private financing is generally used to fund growth, buyouts, acquisitions, recapitalizations, note purchases, and bridge financings. We generally invest in private companies though, from time to time, we may invest in public companies that lack access to public capital or whose securities may not be marginable.

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Our portfolio composition at June 30, 2002 and December 31, 2001 was as follows:

	At June 30, 2002	At December 31, 2001
Private Finance	69%	68%
Commercial Real Estate Finance	31%	32%
Small Business Finance	—%	—%

Our earnings depend primarily on the level of interest and related portfolio income, fee income and net realized and unrealized gains or losses earned on our investment portfolio after deducting interest paid on borrowed capital and operating expenses. Interest income results from the stated interest rate earned on a loan and the amortization of loan origination points and discounts. The level of interest income is directly related to the balance of the interest-bearing investment portfolio multiplied by the weighted average yield. Our ability to generate interest income is dependent on economic, regulatory and competitive factors that influence new investment activity, the amount of loans for which interest is not accruing and our ability to secure debt and equity capital for our investment activities.

## PORTFOLIO AND INVESTMENT ACTIVITY

Total portfolio investment activity and yields at and for the three and six months ended June 30, 2002 and 2001 and at and for the year ended December 31, 2001 were as follows:

	At and for the Three Months Ended June 30,		At and for the Six Months Ended June 30,		At and for the Year Ended December 31,
	2002	2001	2002	2001	2001
(\$ in millions)					
	(unaudited)		(unaudited)		
Portfolio at value	\$2,381.0	\$2,000.6	\$2,381.0	\$2,000.6	\$2,329.6
Investments funded	\$ 115.5	\$ 149.0	\$ 195.5	\$ 299.8	\$ 680.3
Change in accrued or reinvested interest and dividends	\$ 6.2	\$ 10.9	\$ 19.5	\$ 25.5	\$ 51.6
Repayments	\$ 36.0	\$ 12.2	\$ 67.0	\$ 42.5	\$ 74.5
Sales	\$ 1.2	\$ 39.4	\$ 126.3	\$ 74.6	\$ 130.0
Yield*	13.8%	14.2%	13.8%	14.2%	14.3%

\* The weighted average yield on the interest-bearing investments is computed as the (a) annual stated interest rate earned plus the annual amortization of loan origination fees, original issue discount and market discount earned on accruing interest-bearing investments, divided by (b) total interest-bearing investments at value. The weighted average yield is computed as of the balance sheet date.

## Private Finance

The private finance portfolio, investment activity and yields at and for the three and six months ended June 30, 2002 and 2001 and at and for the year ended December 31, 2001 were as follows:

	At and for the Three Months Ended June 30,		At and for the Six Months Ended June 30,		At and for the Year Ended December 31,
	2002	2001	2002	2001	2001
(\$ in millions)	(unaudited)		(unaudited)		
Portfolio at value:					
Loans and debt securities	\$1,050.8	\$1,044.5	\$1,050.8	\$1,044.5	\$1,107.9
Equity interests	584.5	360.9	584.5	360.9	487.2
Total portfolio	\$1,635.3	\$1,405.4	\$1,635.3	\$1,405.4	\$1,595.1
Investments funded	\$ 32.2	\$ 93.3	\$ 69.8	\$ 113.9	\$ 287.7
Change in accrued or reinvested interest and dividends	\$ 7.0	\$ 12.2	\$ 19.1	\$ 24.4	\$ 48.9
Repayments	\$ 27.2	\$ 6.1	\$ 56.0	\$ 23.1	\$ 43.8
Yield*	13.9%	14.6%	13.9%	14.6%	14.8%

\* The weighted average yield on loans and debt securities is computed as the (a) annual stated interest rate earned plus the annual amortization of loan origination fees, original issue discount and market discount earned on accruing loans and debt securities, divided by (b) total loans and debt securities at value. The weighted average yield is computed as of the balance sheet date.

Private finance new investment activity across the industry slowed during 2001, largely due to a lack of available senior debt capital and the state of the economy in general. We believe the level of merger and acquisition activity throughout the U.S. has continued to be depressed into 2002, and we have seen fewer opportunities for mezzanine or equity investment in the first six months of 2002 as compared to 2001. We believe the environment for private finance investing appears to be improving and, although the merger and acquisition environment remains slow, we are seeing more new investment opportunities related to recapitalization and growth financings. In the third quarter of 2002, we have completed two financings totaling \$51 million to date. We are also beginning to see increasing activity within our own portfolio as there are several companies in the private finance portfolio that are in the process of exploring sale, initial public offering or recapitalization events. This means that we may see opportunities to continue our involvement with some of these companies by financing the buyout or recapitalization transactions. This activity could also result in additional potential realized or unrealized gains for the remainder of 2002 and into 2003.

Investments funded during the three and six month periods ended June 30, 2002 and the year ended December 31, 2001 consisted of the following:

(\$ in thousands)	Loans and Debt Securities	Equity Interests	Total
<i>For the three months ended June 30, 2002(1)</i>			
Companies more than 25% owned	\$ 12,550	\$ 3,378	\$ 15,928
Companies 5% to 25% owned	5,400	7,000	12,400
Companies less than 5% owned	3,359	463	3,822
Total	\$ 21,309	\$10,841	\$ 32,150

<b><i>For the six months ended June 30, 2002(1)</i></b>			
Companies more than 25% owned	\$ 15,962	\$ 3,759	\$ 19,721
Companies 5% to 25% owned	7,494	7,046	14,540
Companies less than 5% owned	34,023	1,506	35,529
Total	\$ 57,479	\$12,311	\$ 69,790
<b><i>For the year ended December 31, 2001(1)</i></b>			
Companies more than 25% owned	\$ 47,860	\$78,260	\$126,120
Companies 5% to 25% owned	8,203	3,721	11,924
Companies less than 5% owned	142,144	7,548	149,692
Total	\$198,207	\$89,529	\$287,736

(1) The private finance portfolio is presented in three categories—companies more than 25% owned which represent portfolio companies where we directly or indirectly own more than 25% of the outstanding voting securities of such portfolio company and therefore are deemed controlled by us under the 1940 Act; companies owned 5% to 25% which represent portfolio companies where we directly or indirectly own 5% to 25% of the outstanding voting securities of such portfolio company or where we hold one or more seats on the portfolio company's board of directors and, therefore are deemed to be an affiliated person under the 1940 Act; and companies less than 5% owned which represent portfolio companies where we directly or indirectly own less than 5% of the outstanding voting securities of such portfolio company and where we have no other affiliations with such portfolio company.

At June 30, 2002, we had outstanding funding commitments of \$69.0 million to portfolio companies, including \$31.6 million committed to private venture capital funds.

We fund new investments using cash, through the issuance of our common equity, the reinvestment of previously accrued interest and dividends in debt or equity securities, or the current reinvestment of interest and dividend income through the receipt of a debt or equity security (payment-in-kind income). From time to time we may opt to reinvest accrued interest receivable in a new debt or equity security, in lieu of receiving such interest in cash and providing a subsequent growth investment.

We may acquire more than 50% of the common stock of a company in a control buyout transaction. Control investments are generally structured such that we earn a current return through a combination of interest income on our senior loans and subordinated debt, dividends on our preferred and common stock, and management or transaction services fees to compensate us for the managerial assistance that we provide to a controlled portfolio company. In some cases for companies that are more than 50% owned, we may not accrue interest on loans and debt securities if such company is in need of additional capital and, therefore, we may defer current debt service. Our most significant investments acquired through control buyout transactions at June 30, 2002 were The Hillman Companies, Inc., (formerly SunSource, Inc.), acquired in 2001, Business Loan Express, Inc., acquired in 2000 and WyoTech Acquisition Corporation, acquired in 1998.

***The Hillman Companies, Inc.*** During 2001, we acquired 93.2% of the common equity of SunSource, Inc. for \$71.5 million in cash. Subsequently, SunSource completed the sale of its STS business unit and distributed \$16.5 million in cash to us, reducing our common stock cost basis to

\$57.2 million at December 31, 2001. As part of the STS sale, we invested \$3.2 million in the new STS. During the third quarter of 2001, we received fees from SunSource of \$2.8 million related to transaction assistance for the SunSource sale and STS sale, and \$1.6 million for the syndication of SunSource's senior credit facilities. In addition, we realized a gain of \$2.5 million from the sale of warrants prior to the buyout transaction. During the first quarter of 2002, SunSource changed its name to The Hillman Companies, Inc., also referred to as Hillman. At June 30, 2002, our investment in Hillman totaled \$131.0 million at value, or 5% of total assets. The value of our investment in Hillman increased by \$32.8 million during the second quarter of 2002 as discussed below.

Hillman is a leading manufacturer of key making equipment and distributor of key blanks, fasteners, signage and other small hardware components and operates in multiple channels of the retail marketplace such as hardware stores, national and regional home centers and mass merchants. Hillman has certain patent-protected products including key duplication technology that is important to its business. Hillman's primary operations are located in Cincinnati, Ohio.

For the six months ended June 30, 2002, Hillman had total revenue of \$139 million, earnings before interest, taxes, depreciation, amortization and management fees, or EBITDAM, of \$23 million, and profits before taxes of \$3 million. Hillman is above plan for the year and as of June 30, 2002, is projected to achieve revenues of approximately \$276 million, EBITDAM of approximately \$50 million, and profits before taxes of approximately \$7 million for the year ending December 31, 2002. Hillman had total assets of \$360 million and total debt of \$141 million at June 30, 2002. Hillman is current on all of its debt obligations and is in compliance with all debt covenants.

**Business Loan Express, Inc.** On December 31, 2000, we acquired 94.9% of BLC Financial Services, Inc. in a "going private" buyout transaction for \$95.2 million. We issued approximately 4.1 million shares of our common stock, or \$86.1 million of new equity, and paid \$9.1 million in cash to acquire BLC, which thereafter changed its name to Business Loan Express, Inc.

As part of the transaction, we recapitalized Allied Capital Express, our small business lending operation, as an independently managed private portfolio company and merged it into Business Loan Express. We contributed certain assets, including our online rules-based underwriting technology and fixed assets, and transferred 37 employees to the private portfolio company. Upon completion of the transaction, our investment in Business Loan Express as of December 31, 2000 totaled \$204.1 million and consisted of \$74.5 million of subordinated debt, \$25.1 million of preferred stock, and \$104.5 million of common stock. At June 30, 2002, our investment in Business Loan Express totaled \$251.9 million at value, or 9.8% of our total assets. During the second quarter of 2002, the value of our investment in Business Loan Express increased by \$19.9 million, and as of June 30, 2002, we have recorded total unrealized appreciation of \$35.4 million on this investment.

Business Loan Express is the nation's second largest non-bank government guaranteed lender utilizing the Small Business Administration's 7(a) Guaranteed Loan Program and is licensed by the Small Business Administration as a Small Business Lending Company (SBLC). Therefore, changes in the laws or regulations that govern SBLCs or the Small Business Administration's 7(a) Guaranteed Loan Program or changes in government

funding for this program could have a material impact on Business Loan Express or its operations. Business Loan Express is a preferred lender as designated by the Small Business Administration in 67 markets across the United States, and originates, sells and services small business loans. In addition to the 7(a) Guaranteed Loan Program, Business Loan Express originates loans under the USDA Business and Industry Guaranteed Loan Program and originates conventional small business loans. Business Loan Express has offices in 35 cities and is headquartered in New York, New York.

Unaudited financial data for Business Loan Express at and for the year ended June 30, 2002 was as follows:

	At and for the Year Ended June 30, 2002(1) (unaudited)
(\$ in millions)	
<b>Operating Data</b>	
Total revenue	\$ 84.6
Profits before taxes	\$ 3.6
Earnings before interest, taxes and management fees (EBITM)	\$ 43.0
<b>Balance Sheet Data</b>	
Total assets(2)	\$ 276.2
Total debt	\$ 183.0
Total shareholders' equity	\$ 59.0
<b>Other Data</b>	
Total loan originations	\$ 565.1
Serviced loan portfolio	\$1,372.6
Number of loans	2,083
Loan delinquencies(3)	9.4%

- (1) Financial results at and for the year ended June 30, 2002 are preliminary and not audited and are therefore subject to adjustment prior to completion of the audit.
- (2) Included in total assets is \$6 million of goodwill. There is no other goodwill on BLX's balance sheet. We acquired 94.9% of BLC Financial Services, Inc. on December 31, 2000. "Push-down" accounting was not required with respect to this transaction; accordingly, goodwill was not recorded by BLX.
- (3) Represents the percentage of loans in the serviced portfolio that are greater than 30 days delinquent, which includes loans in workout status. Delinquencies for the types of small business loans made by BLX typically range between 8% and 12%.

The loans originated by Business Loan Express, or BLX, are generally secured by commercial real estate. Loans originated under the 7(a) Guaranteed Loan Program also require the personal guarantee of the borrower and, in many cases, the loans are also secured by additional real estate collateral. Because the loans are secured by collateral, Business Loan Express' annual loan losses for its SBA 7(a) loans, computed using the unguaranteed balance of the SBA 7(a) serviced portfolio, were 0.6% on average for the last five years.

Business Loan Express sells or securitizes substantially all of the loans it originates. BLX currently sells the guaranteed piece of SBA 7(a) guaranteed loans for cash premiums of up to 10% of the guaranteed loan amount plus a retained annual servicing fee

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generally between 1% and 1.6% of the guaranteed loan amount. Alternatively, BLX may sell the guaranteed piece of SBA 7(a) guaranteed loans at par and retain an annual servicing spread, at current prices, of generally between 4.0% and 4.8%. BLX securitizes the unguaranteed piece of the SBA 7(a) loans and other loans it originates. Typically, BLX retains between 0% and 2.7% of the loan securitization pools and receives a spread from the excess of loan interest received on the loans sold over the interest cost on the securities issued in the securitization generally between 4.7% and 4.8%.

As a result of BLX's guaranteed loan sales and as a result of securitization transactions, BLX had assets at June 30, 2002 totaling approximately \$106 million representing the residual interests in and servicing assets for loans sold or securitized, together referred to as Residual Interests. These Residual Interests represent the discounted present value of future cash flow streams to be received from loans sold or securitized after making allowances for prepayments, losses and loan delinquencies.

If loan payments on all loans were to be received as stated in the loan agreements, estimated future cash flows to BLX from loans sold or securitized would total approximately \$412 million in the aggregate over the remaining term of these loans. Of the approximate \$412 million, estimated cash flows for the years ended June 30, 2003, 2004, 2005, and 2006 would be approximately \$33 million, \$31 million, \$30 million and \$29 million, respectively.

Business Loan Express has a three-year \$124 million revolving credit facility. As the controlling shareholder of Business Loan Express, we have provided an unconditional guaranty to the revolving credit facility lenders in an amount of up to 50% of the total obligations (consisting of principal, accrued interest and other fees) of Business Loan Express under the revolving credit facility. The amount guaranteed by us at June 30, 2002 was \$48.1 million. This guaranty can be called by the lenders only in the event of a default by Business Loan Express. Business Loan Express was in compliance with the terms of the revolving credit facility at June 30, 2002. We have also provided two standby letters of credit in connection with two term securitization transactions completed by Business Loan Express in the second quarter of 2002 totaling \$10.6 million.

Business Loan Express is currently contemplating a corporate restructure and recapitalization whereby the company would convert from a corporation to a limited liability company. This restructure would enable the company to have greater flexibility as it grows. Upon such restructure and recapitalization our equity interests would be converted to membership units and the earnings of Business Loan Express would pass through to its members as dividends. There can be no assurance when or if the corporate restructure and recapitalization will occur.

**WyoTech Acquisition Corporation.** On July 1, 2002, we sold WyoTech Acquisition

Corporation for \$84.4 million in cash. We acquired WyoTech in December of 1998 and owned 91% of the common equity of WyoTech. At June 30, 2002, our investment had a cost basis of \$16.4 million, which represented all of the debt (\$12.6 million), preferred stock (\$3.7 million) and 91% of the common equity capital (\$0.1 million) of WyoTech. Our total cash proceeds from the sale of WyoTech, including the repayment of debt and preferred stock and the sale of our 91% common equity ownership, were approximately \$77.0 million, resulting in a realized gain of approximately \$60.6 million on the transaction. At June 30, 2002, we determined the fair value of our investment in WyoTech to be \$77.0 million, which resulted in an increase in fair value during the second quarter of

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\$6.6 million. The sale of WyoTech is subject to post-closing working capital adjustments, if any, and customary indemnification provisions.

### Commercial Real Estate Finance

The commercial real estate finance portfolio, investment activity and yields at and for the three and six months ended June 30, 2002 and 2001 and at and for the year ended December 31, 2001 were as follows:

(\$ in millions)	At and for the Three Months Ended June 30,		At and for the Six Months Ended June 30,		At and for the Year Ended December 31,
	2002	2001	2002	2001	2001
	(unaudited)		(unaudited)		
Portfolio at value:					
CMBS bonds	\$560.9	\$405.5	\$560.9	\$405.5	\$558.3
Collateralized debt obligations	52.5	24.9	52.5	24.9	24.2
Total CMBS	613.4	430.4	613.4	430.4	582.5
Commercial mortgage loans	62.0	87.8	62.0	87.8	79.6
Residual interest	69.0	74.9	69.0	74.9	69.9
Real estate owned	1.3	2.1	1.3	2.1	2.5
Total Portfolio	\$745.7	\$595.2	\$745.7	\$595.2	\$734.5
Investments funded	\$ 83.3	\$ 55.7	\$125.7	\$185.9	\$392.6
Change in accrued or reinvested interest	\$ (0.8)	\$ (1.3)	\$ 0.4	\$ 1.1	\$ 2.7
Repayments	\$ 8.8	\$ 6.1	\$ 11.0	\$ 19.4	\$ 30.7
Sales	\$ 1.2	\$ 39.4	\$126.3	\$ 74.6	\$130.0
Yield*	13.7%	13.6%	13.7%	13.6%	13.5%

\* The weighted average yield on the interest-bearing investments is computed as the (a) annual stated interest rate earned plus the annual amortization of loan origination fees, original issue discount and market discount earned on accruing interest-bearing investments, divided by (b) total interest-bearing investments at value. The weighted average yield is computed as of the balance sheet date. Interest-bearing investments for the commercial real estate finance portfolio include all investments except for real estate owned.

Our primary commercial real estate investment activity is the investment in non-investment



grade commercial mortgage-backed securities, or CMBS. In 1998, we began to take advantage of a unique market opportunity to acquire non-investment grade CMBS bonds at significant discounts from the face amount of the bonds. We believe that CMBS is an attractive asset class because of the yields that can be earned on a security that is secured by commercial mortgage loans, and ultimately commercial real estate properties. We plan to continue our CMBS investment activity, however, in order to maintain a balanced portfolio, we expect that CMBS will continue to represent approximately 20% to 25% of our total assets. Our CMBS investment activity level will be dependent upon our ability to invest in CMBS at attractive yields.

Our commercial real estate investment activity for the three and six months ended June 30, 2002 and for the year ended December 31, 2001 was as follows:

	Amount Invested			Yield(1)
	Face Amount	Discount	Amount Funded	
(\$ in millions)				
For the three months ended June 30, 2002				
CMBS bonds	\$143.3	\$(65.0)	\$78.3	13.9%
CDOs	4.9	—	4.9	16.6%
Commercial mortgage loans	0.1	—	0.1	10.0%
Total	\$148.3	\$(65.0)	\$83.3	14.0%

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	Amount Invested			Yield(1)
	Face Amount	Discount	Amount Funded	
(\$ in millions)				
<i>For the six months ended June 30, 2002</i>				
CMBS bonds	\$181.4	\$ (83.8)	\$ 97.6	14.7%
CDOs	28.0	—	28.0	17.5%
Commercial mortgage loans	0.1	—	0.1	10.0%
Total	<u>\$209.5</u>	<u>\$ (83.8)</u>	<u>\$125.7</u>	15.2%
<i>For the year ended December 31, 2001</i>				
CMBS bonds	\$661.4	\$(295.6)	\$365.8	14.0%
CDOs	24.6	—	24.6	16.9%
Commercial mortgage loans	2.2	—	2.2	10.0%
Total	<u>\$688.2</u>	<u>\$(295.6)</u>	<u>\$392.6</u>	14.2%

(1) The yield on new CMBS bond investments will vary from period to period depending on the concentration of lower yielding BB+, BB and BB- CMBS bonds purchased in that period to the total amount invested.

**CMBS Bonds.** The non-investment grade and unrated tranches of the CMBS bonds in which we invest are junior in priority for payment of interest and principal to the more senior tranches of the related CMBS bond issuance. Cash flow from the underlying mortgages generally is allocated first

to the senior tranches, with the most senior tranches having a priority right to the cash flow. Then, any remaining cash flow is allocated, generally, among the other tranches in order of their relative seniority. To the extent there are defaults and unrecoverable losses on the underlying mortgages resulting in reduced cash flows, our most subordinate tranche will bear this loss first. At June 30, 2002, our CMBS bonds were subordinate to 92% to 97% of the tranches of bonds issued in various CMBS transactions. Given that the non-investment grade CMBS bonds in which we invest are junior in priority for payment of principal, we invest in these CMBS bonds at an approximate discount of 50% from the face amount of the bonds.

The underlying pools of mortgage loans that are collateral for our new CMBS bond investments for the six months ended June 30, 2002 and for the year ended December 31, 2001 had respective underwritten loan to value and underwritten debt service coverage ratios as follows:

Loan to Value Ranges (\$ in millions)	For the Six Months Ended June 30,		For the Year Ended December 31,	
	2002		2001	
	Amount	Percentage	Amount	Percentage
Less than 60%	\$ 401.9	16%	\$1,259.7	15%
60-65%	178.7	7	941.6	11
65-70%	264.1	11	1,140.6	14
70-75%	799.5	32	2,400.4	29
75-80%	812.7	33	2,466.4	30
Greater than 80%	12.0	1	119.6	1
Total	<u>\$2,468.9</u>	<u>100%</u>	<u>\$8,328.3</u>	<u>100%</u>
Weighted average loan to value	70.4%		69.7%	

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Debt Service Coverage Ratio(1) Ranges (\$ in millions)	For the Six Months Ended June 30,		For the Year Ended December 31,	
	2002		2001	
	Amount	Percentage	Amount	Percentage
Greater than 2.00	\$ 103.3	4%	\$ 484.8	6%
1.76-2.00	84.2	3	158.2	2
1.51-1.75	240.3	10	855.0	10
1.26-1.50	1,631.8	66	5,008.3	60
1.00-1.25	409.3	17	1,822.0	22
Total	<u>\$2,468.9</u>	<u>100%</u>	<u>\$8,328.3</u>	<u>100%</u>
Weighted average debt service coverage ratio	1.41		1.48	

(1) Defined as annual net cash flow before debt service divided by annual debt service payments.

As a part of our strategy to maximize our return on equity capital, we sold CMBS bonds rated

BB+, BB and BB- during the six months ended June 30, 2002, and during 2001 totaling \$123.3 million and \$124.5 million, respectively. These bonds had an effective yield of 11.2% and 10.3%, and were sold for \$128.8 million and \$126.8 million, respectively, resulting in realized gains on the sales. The sales of these lower-yielding bonds increased our overall liquidity. We did not sell any CMBS bonds during the second quarter of 2002.

The effective yield on our CMBS portfolio at June 30, 2002 and December 31, 2001 was 14.6% and 14.7%, respectively. The yield on the CMBS portfolio at any point in time will vary depending on the concentration of lower yielding BB+, BB and BB- CMBS bonds held in the portfolio. At June 30, 2002 and December 31, 2001, the unamortized discount related to the CMBS portfolio was \$645.0 million and \$611.9 million, respectively. At June 30, 2002, the CMBS bond portfolio had a fair value of \$560.9 million, which included net unrealized appreciation on the CMBS bonds of \$23.9 million.

At June 30, 2002, the underlying pools of mortgage loans that are collateral for our CMBS bonds consisted of approximately 4,100 commercial mortgage loans with a total outstanding principal balance of \$22.9 billion. At June 30, 2002 and December 31, 2001, 0.75% and 0.52%, respectively, of the loans in the underlying collateral pool for our CMBS bonds were over 30 days delinquent or were classified as real estate owned.

On July 31, 2002, we sold \$129.8 million of face amount of CMBS bonds, with a cost basis of \$82.7 million, and recognized a gain on the sale of approximately \$12 million. The CMBS bonds sold represent a strip of BB+ through B from our portfolio and had a weighted average yield to maturity of 12%. The CMBS bonds were sold to institutional investors. We had recorded approximately \$5 million in net unrealized appreciation, which is net of unrealized depreciation on the related hedge of approximately \$1 million, related to these CMBS bonds in the second quarter of 2002. Therefore, this sale will contribute earnings of approximately \$7 million to the third quarter of 2002. Upon completion of the CMBS bond sale, we continue to own \$471.3 million of non-investment grade CMBS bonds at value with a yield to maturity of 15.2%.

***Collateralized Debt Obligations.*** During the six months ended June 30, 2002, and the year ended December 31, 2001, we invested in the preferred shares of two and one, respectively, collateralized debt obligations, or CDOs, which are secured by investment grade unsecured debt issued by various real estate investment trusts, or REITs, and investment and non-investment grade CMBS bonds. The investment grade REIT debt

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collateral consists of \$852.8 million issued by 39 REITs. The investment grade CMBS collateral consists of CMBS bonds with a face amount of \$402.1 million issued in 26 separate CMBS transactions. The non-investment grade CMBS collateral consists of BB+, BB and BB- CMBS bonds with a face amount of \$405.0 million that were issued in 30 separate CMBS transactions. Included in the CMBS collateral for the CDOs are \$393.8 million of CMBS bonds that are senior in priority of repayment to certain lower rated CMBS bonds held by us, which were issued in 22 separate CMBS transactions. The preferred shares are junior in priority for payment of principal to the more senior tranches of debt issued by the CDOs. To the extent there are defaults and

unrecoverable losses on the underlying collateral resulting in reduced cash flows, the preferred shares will bear this loss first. At June 30, 2002, our preferred shares in the CDOs were subordinate to approximately 95% of the more senior tranches of debt issued by the CDOs. The yield on the CDOs was 17.2% and 16.9% at June 30, 2002, and December 31, 2001, respectively.

**Commercial Mortgage Loans.** We have been liquidating much of our whole commercial mortgage loan portfolio so that we can redeploy the proceeds into higher yielding assets. For the three and six months ended June 30, 2002, and for the year ended December 31, 2001, we sold \$1.2 million, \$3.0 million and \$5.5 million, respectively, of commercial mortgage loans. At June 30, 2002, our whole commercial real estate loan portfolio had been reduced to \$62.0 million from \$79.6 million at December 31, 2001.

**Residual Interests.** The residual interest primarily consists of a retained interest totaling \$68.9 million from a 1998 asset securitization whereby bonds were sold in three classes rated AAA, AA and A. The residual interest represents a right to cash flows from the underlying collateral pool of loans after these senior bond obligations are satisfied. At June 30, 2002, two classes of bonds rated AAA and AA+ are outstanding, for total bonds outstanding of \$29.6 million. On August 9, 2002, the bonds rated AA+ were upgraded to AAA. We have the right to call the bonds when the outstanding bond balance is less than \$23.9 million. Once the bonds are fully repaid, either through the cash flows from the securitized loans or due to us calling the bonds, the remaining loans in the trust will be returned to us as payment on the residual interest. At June 30, 2002, the residual interest had a fair value of \$69.0 million.

### Portfolio Asset Quality

We employ a standard grading system for the entire portfolio. Grade 1 is used for those investments from which a capital gain is expected. Grade 2 is used for investments performing in accordance with plan. Grade 3 is used for investments that require closer monitoring; however, no loss of interest or principal is expected. Grade 4 is used for investments that are in workout and for which some loss of current interest is expected, but no loss of principal is expected. Grade 5 is used for investments that are in workout and for which some loss of principal is expected and the investment is written down to net realizable value.

At June 30, 2002 and December 31, 2001, our portfolio was graded as follows:

Grade (\$ in millions)	2002		2001	
	Portfolio at Value	Percentage of Total Portfolio	Portfolio at Value	Percentage of Total Portfolio
1	\$ 793.6	33.3%	\$ 603.3	25.9%
2	1,400.0	58.8	1,553.8	66.7
3	46.7	2.0	79.5	3.4
4	43.6	1.8	44.5	1.9
5	97.1	4.1	48.5	2.1

<u>\$2,381.0</u>	<u>100.0%</u>	<u>\$2,329.6</u>	<u>100.0%</u>
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Total Grades 4 and 5 assets as a percentage of the total portfolio at value at June 30, 2002 and December 31, 2001 were 5.9% and 4.0%, respectively. We expect that a number of portfolio companies will be in the Grades 4 or 5 categories from time to time. Part of the business of private finance is working with troubled portfolio companies to improve their businesses and protect our investment. The number of portfolio companies and related investment amount included in Grades 4 and 5 may fluctuate significantly from period to period. We continue to follow our historical practice of working with a troubled portfolio company in order to recover the maximum amount of our investment, but record unrealized depreciation for the expected full amount of the potential loss when such exposure is identified.

For the total investment portfolio, workout loans not accruing interest, or those loans in Grade 4 and 5, were \$121.4 million at value at June 30, 2002, or 5.1% of the total portfolio. Included in this category at June 30, 2002, were assets valued at \$8.9 million that represent receivables related to companies in liquidation and loans of \$16.2 million that were secured by commercial real estate. Workout loans not accruing interest were \$109.0 million at value at December 31, 2001 or 4.7% of the total portfolio of which \$8.9 million represented receivables related to companies in liquidation, and \$15.2 million represented loans secured by commercial real estate. In addition to Grade 4 and 5 assets that are in workout, we may not accrue interest on loans to companies which are more than 50% owned by us from time to time if such companies are in need of additional capital and, therefore, we may defer current debt service. Loans and debt securities to such companies totaled \$61.3 million at value at June 30, 2002. Loans greater than 90 days delinquent were \$89.4 million at value at June 30, 2002, or 3.8% of the total portfolio. Included in this category are loans valued at \$22.0 million that are secured by commercial real estate. Loans greater than 90 days delinquent were \$39.1 million at value at December 31, 2001 or 1.7% of the total portfolio. Included in this category are loans valued at \$14.1 million that were secured by commercial real estate.

As a provider of long-term privately negotiated investment capital, we may defer payment of principal or interest from time to time. As a result, the amount of the portfolio that is greater than 90 days delinquent or on non-accrual status may vary from quarter to quarter. The nature of our private finance portfolio company relationships frequently provide an opportunity for portfolio companies to amend the terms of payment to us or to restructure their debt and equity capital. During such restructuring, we may not receive or accrue interest or dividend payments. The investment portfolio is priced to provide current

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returns for shareholders assuming that a portion of the portfolio at any time may not be accruing interest currently. We also price our investments for a total return including interest or dividends plus capital gains from the sale of equity securities. Therefore, the amount of loans greater than 90 days delinquent or on non-accrual status is not necessarily an indication of future principal loss or loss of anticipated investment return. Our portfolio grading system is used as a means to assess loss of investment principal (Grade 5 assets).

At June 30, 2002 and December 31, 2001, 0.75% and 0.52% of the loans in the underlying

collateral pool for our CMBS bond portfolio were over 30 days delinquent or were classified as real estate owned. We closely monitor the performance of all of the loans in the underlying collateral pools securing our CMBS investments.

### Other Assets and Other Liabilities

Because we invest in BB+, BB and BB- rated CMBS bonds, which are purchased at prices that are based on the 10-year Treasury rate, we have entered into transactions with financial institutions to hedge against movement in Treasury rates on certain of these CMBS bonds. These transactions involved receiving the proceeds from the sales of the borrowed Treasury securities, with the obligations to replenish the borrowed Treasury securities at a later date based on the then current market price.

The total obligations to replenish borrowed Treasury securities were \$84.8 million and \$47.3 million at June 30, 2002 and December 31, 2001, respectively, which included unrealized depreciation on the obligations of \$2.2 million and unrealized appreciation on the obligations of \$1.2 million, respectively, due to changes in the yield on the borrowed Treasury securities. The obligations have been recorded as an other liability. The proceeds related to the sales of the borrowed Treasury securities were \$82.6 million and \$48.5 million at June 30, 2002 and December 31, 2001, respectively, and have been recorded as an other asset.

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## RESULTS OF OPERATIONS

### Comparison of Three Months Ended June 30, 2002 and 2001

The following table summarizes our condensed operating results for the three months ended June 30, 2002 and 2001.

(\$ in thousands, except per share amounts)	For the Three Months Ended June 30,		Change	Percent Change
	2002	2001		
	(unaudited)			
<b>Interest and Related Portfolio Income</b>				
Interest and dividends	\$ 62,692	\$58,824	\$ 3,868	7%
Premiums from loan dispositions	46	910	(864)	(95%)
Fees and other income	10,455	9,005	1,450	16%
Total interest and related portfolio income	73,193	68,739	4,454	6%
<b>Expenses</b>				
Interest	17,515	15,951	1,564	10%
Employee	8,274	7,610	664	9%
Administrative	4,843	3,060	1,783	58%
Total operating expenses	30,632	26,621	4,011	15%

Net investment income before net realized and unrealized gains	42,561	42,118	443	1%
<b>Net Realized and Unrealized Gains</b>				
Net realized gains (losses)	(755)	3,837	(4,592)	*
Net unrealized gains	31,648	151	31,497	*
Total net realized and unrealized gains	30,893	3,988	26,905	*
Net increase in net assets resulting from operations	\$ 73,454	\$46,106	\$27,348	59%
Diluted earnings per share	\$ 0.71	\$ 0.51	\$ 0.20	39%
Weighted average shares outstanding — diluted	103,440	90,848	12,592	14%

\* Net realized and net unrealized gains and losses can fluctuate significantly from quarter to quarter. As a result, quarterly comparisons of net realized and net unrealized gains and losses may not be meaningful.

Net increase in net assets resulting from operations, or net income, results from total interest and related portfolio income earned, less total expenses incurred in our operations, plus net realized and unrealized gains or losses.

**Total Interest and Related Portfolio Income.** Total interest and related portfolio income includes interest income, premiums from loan dispositions and fees and other income.

	For the Three Months Ended June 30,	
	2002	2001
(\$ in millions, except per share amounts)		
Total Interest and Related Portfolio Income	\$73.2	\$68.7
Per share	\$0.71	\$0.76

The increase in interest income earned results primarily from the growth of our investment portfolio. Our investment portfolio, excluding non-interest bearing equity

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interests in portfolio companies, increased by 10% to \$1,796.5 million at June 30, 2002 from \$1,639.7 million at June 30, 2001. The weighted average yield on the interest-bearing investments in the portfolio at June 30, 2002 and 2001 was as follows:

	June 30,	
	2002	2001
Private Finance	13.9%	14.6%
Commercial Real Estate Finance	13.7%	13.6%
Total Portfolio	13.8%	14.2%

Included in premiums from loan dispositions are prepayment premiums of \$0 and \$0.1 million for the three months ended June 30, 2002 and 2001, respectively. While the scheduled maturities of private finance and commercial real estate loans range from five to ten years, it is not unusual for

our borrowers to refinance or pay off their debts to us ahead of schedule. Because we seek to finance primarily seasoned, performing companies, such companies at times can secure lower cost financing as their balance sheets strengthen, or as more favorable interest rates become available. Therefore, we generally structure our loans to require a prepayment premium for the first three to five years of the loan.

Fees and other income primarily include fees related to financial structuring, diligence, management services to portfolio companies, guaranties and other advisory services. We generate fee income for the transaction services and management services that we provide. As a business development company, we are required to make significant managerial assistance available to the companies in our investment portfolio. Managerial assistance includes management and consulting services including, but not limited to, information technology, web site development, marketing, human resources, personnel recruiting, board recruiting, corporate governance and risk management.

Fees and other income for the quarter ended June 30, 2002 included fees of \$2.6 million related to structuring and diligence, fees of \$1.8 million related to transaction services provided to portfolio companies, and fees of \$6.0 million related to management services provided to portfolio companies, guaranty and other advisory services. Fees and other income are generally related to specific transactions or services, and therefore may vary substantially from period to period. Points or loan origination fees that represent yield enhancement on a loan are capitalized and amortized into interest income over the life of the loan.

Business Loan Express, Hillman and WyoTech are our most significant portfolio investments and together represent 17.9% of our total assets at June 30, 2002. Total interest and related portfolio income earned from these investments for the three months ended June 30, 2002 and 2001 was \$14.0 million and \$10.2 million, respectively. Total interest and related portfolio income earned from WyoTech for the three months ended June 30, 2002 was \$1.8 million, which will no longer occur due to the sale of the investment on July 1, 2002.

**Operating Expenses.** Operating expenses include interest, employee and administrative expenses. Our single largest expense is interest on our indebtedness. The fluctuations in interest expense during the three months ended June 30, 2002 and 2001 are attributable to changes in the level of our borrowings under various notes payable and debentures and

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our revolving credit facility. Our borrowing activity and weighted average interest cost, including fees and closing costs, were as follows:

	At and for the Three Months Ended June 30,	
	2002	2001
(\$ in millions)		
Total Outstanding Debt	\$1,009.0	\$881.1
Average Outstanding Debt	\$ 942.3	\$812.5



Weighted Average Cost  
BDC Asset Coverage\*

7.2% 7.4%  
256% 247%

\* As a business development company, we are generally required to maintain a minimum ratio of 200% of total assets to total borrowings.

Employee expenses include salaries and employee benefits. The increase in salaries and employee benefits for the periods presented reflects wage increases and the experience level of employees hired. Total employees were 103 and 101 at June 30, 2002 and 2001, respectively.

Administrative expenses include the leases for our headquarters in Washington, DC, and our regional offices, travel costs, stock record expenses, directors' fees, legal and accounting fees, insurance premiums and various other expenses. The increase in administrative expenses as compared to the same period in 2001 includes approximately \$1.2 million from legal, consulting and other fees, including costs incurred to defend against class action lawsuits alleging violations of securities laws and to respond to market activity in our stock. Administrative expenses also increased by approximately \$0.1 million due to increased costs for corporate liability insurance, \$0.3 million due to outsourced technology assistance, and \$0.2 million due to travel costs, including corporate aircraft depreciation.

**Realized Gains and Losses.** Net realized gains (losses) resulted from the sale of equity securities associated with certain private finance investments and the realization of unamortized discount resulting from the sale and early repayment of private finance loans, commercial mortgage loans and CMBS bonds, offset by losses on investments. Net realized and unrealized gains and losses were as follows:

	(\$ in millions)	For the Three Months Ended June 30,	
		2002	2001
Realized Gains		\$ 2.5	\$ 4.7
Realized Losses		(3.3)	(0.9)
Net Realized Gains (Losses)		\$ (0.8)	\$ 3.8
Net Unrealized Gains		\$31.6	\$ 0.2

Realized gains and losses for the three months ended June 30, 2002, resulted from various private finance and commercial real estate finance transactions. Realized gains for the three months ended June 30, 2002, primarily resulted from transactions involving two

private finance portfolio companies, Cumulus Media, Inc. (\$0.5 million) and Alderwoods Group, Inc. (\$0.1 million), and one commercial real estate investment (\$1.3 million). We reversed previously recorded unrealized appreciation totaling \$2.1 million and \$2.9 million when gains were realized for the three months ended June 30, 2002 and 2001, respectively.

Realized losses for the three months ended June 30, 2002, primarily resulted from transactions involving three private finance portfolio companies, iSolve Incorporated (\$0.9 million), Sure-Tel, Inc. (\$0.5 million) and Soff-Cut Holdings, Inc. (\$0.5 million), and one commercial real estate investment (\$1.1 million). We reversed previously recorded unrealized depreciation totaling \$2.0 million and \$1.5 million when losses were realized for the three months ended June 30, 2002 and 2001, respectively.

**Unrealized Gains and Losses.** We determine the fair value of each investment in our portfolio on a quarterly basis, and changes in fair value result in unrealized gains or losses being recognized. At June 30, 2002, \$2,381.0 million, or 93% of our total assets, represented investments recorded at value. Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the board of directors. Since there is typically no ready market for the investments in our portfolio, we value substantially all of our investments at fair value as determined in good faith by the board of directors pursuant to a valuation policy and a consistently applied valuation process. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily ascertainable market value, the fair value of our investments determined in good faith by the board of directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

There is no single standard for determining fair value in good faith. As a result, determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment while employing a consistently applied valuation process for the types of investments we make. Unlike banks, we are not permitted to provide a general reserve for anticipated loan losses. Instead, we must determine the fair value of each individual investment on a quarterly basis. We will record unrealized depreciation on investments when we believe that an investment has become impaired, including where collection of a loan or realization of an equity security is doubtful. Conversely, we will record unrealized appreciation if we have an indication that the underlying portfolio company has appreciated in value and, therefore, our equity security has also appreciated in value, where appropriate. Changes in fair value are recorded in the statement of operations as unrealized gains and losses.

As a business development company, we invest primarily in illiquid securities including debt and equity securities of private companies and non-investment grade CMBS. The structure of each debt and equity security is specifically negotiated to enable us to protect our investment and maximize our returns. We include many terms governing interest rate, repayment terms, prepayment penalties, financial covenants, operating covenants, ownership parameters, dilution parameters, liquidation preferences, voting rights, and put or call rights. Our investments are generally subject to restrictions on resale and generally have no established trading market. Because of the type of investments that we make and the nature of our business, our valuation process requires an analysis of various factors. Our fair value methodology includes the examination of, among other things, the underlying investment performance, financial condition and market changing events that impact valuation.

*Valuation Methodology — Private Finance.* Our process for determining the fair value of a private finance investment begins with determining the enterprise value of the portfolio company. The fair value of our investment is based upon the enterprise value at which the portfolio company could be sold in an orderly disposition over a reasonable period of time between willing parties other than in a forced or liquidation sale. The liquidity event whereby we exit a private finance investment is generally the sale, the recapitalization or, in some cases, the initial public offering of the portfolio company.

There is no one methodology to determine enterprise value and, in fact, for any one portfolio company, enterprise value is best expressed as a range of fair values, from which we derive a single estimate of enterprise value. To determine the enterprise value of a portfolio company, we analyze its historical and projected financial results. We generally require portfolio companies to provide annual audited and monthly unaudited financial statements, as well as annual projections for the upcoming fiscal year. Typically in the private equity business, companies are bought and sold based upon multiples of EBITDA, cash flow, net income, revenues or, in limited instances, book value. When using EBITDA to determine enterprise value, we may adjust EBITDA for non-recurring items. Such adjustments are intended to normalize EBITDA to reflect the portfolio company's earnings power. Adjustments to EBITDA may include compensation to previous owners, or acquisition, recapitalization or restructuring related items.

In determining a multiple to use for valuation purposes, we look to private merger and acquisition statistics, discounted public trading multiples or industry practices. In estimating a reasonable multiple, we consider not only the fact that our portfolio company may be private relative to a peer group, but the size and scope of our portfolio company and its specific strengths and weaknesses. In some cases, the best valuation methodology may be a discounted cash flow analysis based upon future projections. If a portfolio company is distressed, a liquidation analysis may provide the best indication of enterprise value.

If there is adequate enterprise value to support the repayment of our debt, the fair value of our loan or debt security normally corresponds to cost unless the borrower's condition or other factors lead to a determination of fair value at a different amount. The fair value of equity interests in portfolio companies are determined based upon various factors, including the enterprise value remaining for equity holders after the repayment of the portfolio company's debt and other pertinent factors such as recent offers to purchase a portfolio company's equity interest or other potential liquidity events. The determined equity values are generally discounted when we have a minority position, restrictions on resale, specific concerns about the receptivity of the capital markets to a specific company at a certain time, or other factors.

*Valuation Methodology — CMBS Bonds.* CMBS bonds are carried at fair value, which is based upon a discounted cash flow model which utilizes prepayment and loss assumptions based upon historical experience and projected performance, economic factors and the characteristics of the underlying cash flow. Our assumption with regard to discount rate is based upon the yield of comparable securities. We recognize income from the amortization of original issue discount using the effective interest method, using the anticipated yield over the projected life of the investment. Yields are revised when there are changes in estimates of future credit losses, actual losses incurred, or actual and estimated prepayment speeds. Changes in estimated yield are recognized as an

adjustment to the estimated yield over the remaining life of the CMBS bonds from the date the estimated yield is changed. We recognize unrealized appreciation or depreciation on our

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CMBS bonds, as comparable yields in the market change and/or whenever we determine that the value of our CMBS bonds is less than the cost basis due to impairment in the underlying collateral pool.

Net unrealized gains for the second quarter of 2002 were \$31.6 million, which included \$113.8 million of unrealized gains and \$82.2 million of unrealized losses.

*Private Finance.* We increased the fair value of our investment in The Hillman Companies, Inc. by \$32.8 million in the second quarter of 2002. The fair value of our investment in Hillman is based upon our estimate of Hillman's enterprise value of approximately \$350 million, including all debt. As discussed above, there is no one methodology to determine enterprise value. As multiples or EBITDAM fluctuate over time, this may or may not impact our estimate of Hillman's enterprise value. The following is a simplified summary of the methodology that we used to determine the fair value of our investment in Hillman.

Since Hillman's results can be affected by seasonal changes, we believe using projected 2002 results for valuation purposes is most appropriate. Hillman is performing better than Hillman's originally projected 2002 revenue and EBITDAM estimates, resulting in part from the closing of a former corporate headquarters for cost savings, the completion of an acquisition and successful expansion into Canada. Hillman is above its original projections for the year as of June 30, 2002, and its 2002 revenue and EBITDA is expected to exceed revenue and EBITDA for 2001.

We believe the current enterprise value for Hillman is approximately \$350 million, or approximately 7 times 2002 projected EBITDAM of \$50 million. The 7 times multiple was determined by obtaining the average multiple of enterprise value to EBITDA for comparable public companies in Hillman's peer group and discounting that average multiple to arrive at a private company multiple. We then subtracted Hillman's debt (including \$41.0 million of subordinated debt owed to us) and Hillman's trust preferred securities estimated to be currently outstanding to arrive at a common equity value of approximately \$102 million. We then took our 78% fully diluted share of the resulting equity value and added to it the cost basis of our share of two securities, including a note receivable from GC-Sun Holdings II, LP (Kar Products, LP) and preferred stock of STS Operating, Inc., owned by Hillman that are anticipated to be distributed to us in the third quarter of 2002. We arrived at a total fair value of our common equity of approximately \$90 million. We compared the \$90 million fair value to our basis in Hillman's common equity of \$57.2 million and recorded an unrealized gain of \$32.8 million.

We increased the fair value of our investment in Business Loan Express, or BLX, by \$19.9 million in the second quarter of 2002 or just slightly under 10% of the total amount invested. BLX has just completed its first full fiscal year of operations since our acquisition of the company in December 2000. During 2002, BLX achieved most of its goals, including launching a conventional small business loan product. The fair value for our investment in BLX is based upon

our estimate of BLX's enterprise value of approximately \$390 million, including all debt. As discussed above, there is no one methodology to determine enterprise value. The following is a simplified summary of the methodology that we used to determine the fair value of our investment in BLX.

To determine the enterprise value of BLX, we determined that financial services companies are generally valued using multiples of net income. We have capitalized BLX with \$87 million of subordinated debt. For purposes of valuation, we assumed in a sale transaction that a portion of this \$87 million would be considered equity and that BLX would increase the size of its senior debt facility to approximately \$155 million. Given this

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assumption, we then computed a pro forma net income for BLX taking its preliminary, unaudited 2002 earnings before interest, taxes and management fees, and subtracting pro forma interest, assuming the higher level of senior debt and no outstanding subordinated debt. We then computed taxes at a rate of 40 percent, which resulted in pro forma net income for BLX of approximately \$23 million for fiscal year 2002 and a projected pro forma net income for fiscal year 2003 of approximately \$26 million. We then performed three valuation analyses to determine the fair value of BLX — assuming an initial public offering of BLX, assuming the sale of BLX, and, lastly, considering discounted trading ranges for similar companies in the public markets. In performing these analyses, we used a publicly traded peer group and reviewed merger and acquisition transactions that occurred in the last five years in the commercial finance sector. These analyses resulted in a range of estimated enterprise values, and we selected \$390 million, which was at the low end of the range. After deducting outstanding debt and preferred stock from the enterprise value to reach an equity value, we determined the value of our 92.8% fully diluted common equity interest to be approximately \$140.0 million. We compared the \$140.0 million fair value to the fair value of our common equity at March 31, 2002 of \$120.1 million, and recorded an unrealized gain of \$19.9 million in the second quarter of 2002. As multiples or pro forma net income fluctuate over time, this may or may not impact our determination of the fair value of our investment in BLX.

During the second quarter of 2002, we also increased the fair value of: WyoTech Acquisition Corporation by \$6.6 million based on the proceeds received from the sale of this investment in July 2002; Blue Rhino and Kirkland's by \$7.8 million and \$5.7 million, respectively, based on the public market valuations of each company's stock; and CorrFlex Graphics LLC by \$11.8 million based on strong earnings growth and upon indicative valuation estimates received from third parties. In addition, we recorded unrealized appreciation totaling \$14.0 million on nine other investments in our portfolio.

During the second quarter of 2002, we decreased the fair value of our investment in Startec Global Communications Corporation by \$10.2 million to reflect the current plan of reorganization filed with the bankruptcy court this quarter. We also decreased the fair value of our investment in Velocita, Inc. by \$4.3 million. Velocita filed for bankruptcy under Chapter 11 in June 2002, and, based upon the assessment of an independent third party regarding Velocita's liquidation value, we do not expect to recover our investment. Our investment has a fair value of zero at June 30, 2002.

We also recorded \$69.9 million in unrealized losses during the second quarter of 2002, largely due to conditions in the manufacturing, technology and media sectors, and the continuing effects of the events of September 11th, 2001. Portfolio companies for which unrealized depreciation was recorded this quarter include five companies in the portfolio that have been affected by weakness in the manufacturing sector for which we decreased fair value by \$20.6 million; five companies that have been affected by lower levels of technology spending for which we decreased fair value by \$14.7 million; two companies in the media sector that have declined in fair value due to declining values in this sector for which we decreased fair value by \$7.7 million; and two companies that continued to endure difficulties during the second quarter of 2002 as a result of the attacks of September 11th that have declined in fair value by \$11.3 million. As the economy improves, the financial performance of these portfolio companies may also improve. However, there can be no assurance when or if these companies' performance may improve.

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**CMBS Bonds.** We recorded a net increase in the fair value of our CMBS bond portfolio by \$20.7 million in the second quarter of 2002. We determined the fair value of our CMBS bond portfolio using a discounted cash flow model based upon (i) the current performance of the underlying collateral loans, which utilizes prepayment and loss assumptions based upon historical and projected experience, economic factors and the characteristics of the underlying cash flow, and (ii) current market yields for comparable CMBS bonds, based upon Treasury rates and market spreads.

*Cash flow assumptions.* With respect to the cash flows of the underlying collateral loans securing the CMBS bonds, the performance of the collateral loans to date is generally consistent with our original assumptions. We continue to assume no prepayments on the collateral loans prior to maturity, as prepayments on the loans prior to maturity are generally prohibited or there are significant penalties, such as prepayment premiums, yield maintenance and/or defeasance requirements. Our credit loss assumptions for the underlying collateral loans at the time of investment in the CMBS bonds were generally estimated to assume that approximately 1% of the underlying collateral loan principal would be lost, and that one-third of the losses would be realized in year three, one-third in year six, and one-third in year nine. We believe that this is an appropriate approach to setting loss assumptions, as losses are expected to occur throughout the life of the CMBS bonds. As of June 30, 2002, total estimated losses in the underlying collateral pools over the life of the CMBS bonds were assumed to total approximately \$220 million.

Through June 30, 2002, \$0.5 million in actual losses have been realized, and we have specifically identified approximately \$25.1 million of additional potential losses. The actual losses and potential expected losses of approximately \$25.6 million to date as of June 30, 2002 are less than the losses originally estimated to have been realized by this point, which were estimated at approximately \$51.8 million. While the losses identified as of June 30, 2002 are less than our originally estimated losses, we have not reduced the original estimates of the total expected losses over the life of the CMBS bonds as we continue to believe they are reasonable. Loss assumptions affecting future cash flows are updated quarterly to reflect the estimated current and expected performance of the collateral loans on a loan-by-loan basis.

**Yield assumptions.** During the second quarter of 2002, the overall yields on newly-issued CMBS bonds rated BB+ through B declined due to the decline in Treasury yields combined with the narrowing of spreads, resulting in market yields for these bond classes being lower than the yields-to-maturity on our CMBS bonds for the same classes. More buyers of CMBS bonds have recently entered the market, particularly buyers for BB+ through BB rated CMBS bonds, which has contributed to the decline in spreads for these bond classes during the second quarter. Historically, we have found yields on new issuances to be in the same range as the CMBS bonds we own. We confirmed our CMBS bond portfolio pricing estimates with respect to spreads for our BB+ through B rated bonds with other CMBS bond market participants. Lower yields imply an increase in the value of our BB+ through B rated CMBS bond portfolio. The yields on B- through the non-rated classes have generally remained relatively consistent with the yields on our CMBS bonds in these classes. Pricing for these deeply subordinated classes of bonds are generally much more a function of the credit quality of a single issuance than market conditions.

**Fair Value.** We have determined the fair value of our CMBS bonds based upon a discounted cash flow model using expected future cash flows and current market yields, as discussed above, to be approximately \$560.9 million, and as a result have recorded net unrealized appreciation on the CMBS bonds of \$23.9 million at June 30, 2002.

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Because we invest in BB+, BB and BB- rated CMBS bonds, which are purchased at prices that are based on the 10-year Treasury rate, we have entered into transactions with financial institutions to hedge against movement in Treasury rates on certain of these CMBS bonds. These transactions involved receiving the proceeds from the sales of borrowed Treasury securities, with the obligation to replenish the borrowed Treasury securities at a later date based on the then current market price. The net proceeds related to the sales of the borrowed Treasury securities and the related obligations to replenish the borrowed Treasury securities totaled \$82.6 million and \$84.8 million, respectively, and have been included in other assets and other liabilities, respectively, at June 30, 2002. As of June 30, 2002, the total obligations on the hedge had increased to \$84.8 million due to changes in the yield on the borrowed Treasury securities, resulting in unrealized depreciation on the obligation of \$2.2 million. The decrease in the value of the hedge during the three months ended June 30, 2002 was \$3.2 million and was recorded as an unrealized loss.

The net unrealized gain on the CMBS bonds of \$23.9 million, net of the unrealized loss on the hedge of \$3.2 million, resulted in a net unrealized gain from the CMBS bond portfolio of \$20.7 million for the three months ended June 30, 2002.

Given that Treasury yields fluctuate, it is possible that there may be future adjustments to the fair value of the CMBS bonds. As a result, we have not classified the appreciated CMBS bonds as Grade 1 assets at June 30, 2002, since they may not result in any future capital gain. Therefore, CMBS bonds remain in Grade 2.

**Other Matters.** All per share amounts included in the Management's Discussion and Analysis of Financial Condition and Results of Operations section have been computed using the weighted

average shares used to compute diluted earnings per share, which were 103.4 million and 90.8 million for the three months ended June 30, 2002 and 2001, respectively.

We have elected to be taxed as a regulated investment company under Subchapter M of the Internal Revenue Code of 1986. As long as we qualify as a regulated investment company, we are not taxed on our investment company taxable income or realized capital gains, to the extent that such taxable income or gains are distributed, or deemed to be distributed, to shareholders on a timely basis. Annual tax distributions generally differ from net increase in net assets resulting from operations for the fiscal year due to timing differences in the recognition of income and expenses, returns of capital and net unrealized appreciation or depreciation, which are not included in taxable income.

In order to maintain our status as a regulated investment company, we must, in general, (1) continue to qualify as a business development company; (2) derive at least 90% of our gross income from dividends, interest, gains from the sale of securities and other specified types of income; (3) meet investment diversification requirements as defined in the Internal Revenue Code; and (4) distribute annually to shareholders at least 90% of our investment company taxable income as defined in the Internal Revenue Code. We intend to take all steps necessary to continue to qualify as a regulated investment company. However, there can be no assurance that we will continue to qualify for such treatment in future years.

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## RESULTS OF OPERATIONS

### Comparison of Six Months Ended June 30, 2002 and 2001

The following table summarizes our condensed operating results for the six months ended June 30, 2002 and 2001.

(\$ in thousands, except per share amounts)	For the Six Months Ended June 30,		Change	Percent Change
	2002	2001		
	(unaudited)			
<b>Interest and Related Portfolio Income</b>				
Interest and dividends	\$127,665	\$113,699	\$13,966	12%
Premiums from loan dispositions	1,659	1,731	(72)	(4%)
Fees and other income	26,260	18,380	7,880	43%
Total interest and related portfolio income	155,584	133,810	21,774	16%
<b>Expenses</b>				
Interest	34,984	31,881	3,103	10%
Employee	16,309	14,056	2,253	16%
Administrative	7,861	6,027	1,834	30%
Total operating expenses	59,154	51,964	7,190	14%



Net investment income before net realized and unrealized gains	96,430	81,846	14,584	18%
<b>Net Realized and Unrealized Gains</b>				
Net realized gains	8,850	4,991	3,859	*
Net unrealized gains	24,135	11,297	12,838	*
Total net realized and unrealized gains	32,985	16,288	16,697	*
Net increase in net assets resulting from operations	\$129,415	\$ 98,134	\$31,281	32%
Diluted earnings per share	\$ 1.26	\$ 1.10	\$ 0.16	15%
Weighted average shares outstanding — diluted	102,900	88,966	13,934	16%

\* Net realized and net unrealized gains and losses can fluctuate significantly from period to period. As a result, year-to-date comparisons of net realized and net unrealized gains and losses may not be meaningful.

Net increase in net assets resulting from operations, or net income, results from total interest and related portfolio income earned, less total expenses incurred in our operations, plus net realized and unrealized gains or losses.

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**Total interest and related portfolio income.** Total interest and related portfolio income includes interest income, premiums from loan dispositions and fees and other income.

	For the Six Months Ended June 30,	
	2002	2001
(\$ in millions, except per share amounts)		
Total Interest and Related Portfolio Income	\$155.6	\$133.8
Per share	\$ 1.51	\$ 1.50

The increase in interest income earned results primarily from the growth of our investment portfolio. Our investment portfolio, excluding non-interest bearing equity interests in portfolio companies, increased by 9% to \$1,794.3 million at June 30, 2002 from \$1,639.7 million at June 30, 2001. The weighted average yield on the interest-bearing investments in the portfolio at June 30, 2002 and 2001 was as follows:

	June 30,	
	2002	2001
Private Finance	13.9%	14.6%
Commercial Real Estate Finance	13.7%	13.6%
Total Portfolio	13.8%	14.2%

Included in net premiums from loan dispositions are prepayment premiums of \$1.6 million and \$1.0 million for the six months ended June 30, 2002 and 2001, respectively. While the scheduled maturities of private finance and commercial real estate loans range from five to ten years, it is not

unusual for our borrowers to refinance or pay off their debts to us ahead of schedule. Because we seek to finance primarily seasoned, performing companies, such companies at times can secure lower cost financing as their balance sheets strengthen, or as more favorable interest rates become available. Therefore, we generally structure our loans to require a prepayment premium for the first three to five years of the loan.

Fees and other income primarily include fees related to financial structuring, diligence, management services to portfolio companies, guaranty and other advisory services. We generate fee income for the transaction services and management services that we provide. As a business development company, we are required to make significant managerial assistance available to the companies in our investment portfolio. Managerial assistance includes management and consulting services including, but not limited to, information technology, web site development, marketing, human resources, personnel recruiting, board recruiting, corporate governance and risk management.

Fees and other income for the six months ended June 30, 2002 included fees of \$10.6 million related to structuring and diligence, fees of \$3.8 million related to transaction services provided to portfolio companies, and fees of \$11.7 million related to management services provided to portfolio companies, other advisory services and guaranty fees. Fees and other income are generally related to specific transactions or services, and therefore may vary substantially from period to period. Points or loan origination fees that represent yield enhancement on a loan are capitalized and amortized into interest income over the life of the loan.

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Business Loan Express, Hillman and WyoTech are our most significant portfolio investments and together represent 17.9% of our total assets at June 30, 2002. Total interest and related portfolio income earned from these investments for the six months ended June 30, 2002 and 2001 was \$28.1 million and \$17.8 million, respectively. Total interest and related portfolio income earned from WyoTech for the six months ended June 30, 2002 was \$3.6 million, which will no longer occur due to the sale of the investment.

**Operating Expenses.** Operating expenses include interest, employee and administrative expenses. Our single largest expense is interest on our indebtedness. The fluctuations in interest expense during the six months ended June 30, 2002 and 2001 are attributable to changes in the level of our borrowings under various notes payable and debentures and our revolving credit facility. Our borrowing activity and weighted average interest cost, including fees and closing costs, were as follows:

	At and for the Six Months Ended June 30,	
	2002	2001
(\$ in millions)		
Total Outstanding Debt	\$1,009.0	\$881.1
Average Outstanding Debt	\$ 940.4	\$801.3
Weighted Average Cost	7.2%	7.4%

BDC Asset Coverage\*

256% 247%

\* As a business development company, we are generally required to maintain a minimum ratio of 200% of total assets to total borrowings.

Employee expenses include salaries and employee benefits. The increase in salaries and employee benefits for the periods presented reflects wage increases and the experience level of employees hired. Total employees were 103 and 101 at June 30, 2002 and 2001, respectively.

Administrative expenses include the leases for our headquarters in Washington, DC, and our regional offices, travel costs, stock record expenses, directors' fees, legal and accounting fees, insurance premiums and various other expenses. The increase in administrative expenses as compared to the same period in 2001 includes approximately \$1.2 million from legal, consulting and other fees, including costs incurred to defend against class action lawsuits alleging violations of securities laws and to respond to market activity in our stock. Administrative expenses also increased by approximately \$0.1 million due to increased costs for corporate liability insurance and \$0.5 million due to outsourced technology assistance.

**Realized Gains and Losses.** Net realized gains result from the sale of equity securities associated with certain private finance investments and the realization of unamortized discount resulting from the sale and early repayment of private finance loans,

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commercial mortgage loans and CMBS bonds, offset by losses on investments. Net realized and unrealized gains and losses were as follows:

	(\$ in millions)	For the Six Months Ended June 30,	
		2002	2001
Realized Gains		\$15.4	\$ 6.6
Realized Losses		(6.5)	(1.6)
Net Realized Gains		8.9	5.0
Net Unrealized Gains		\$24.1	\$11.3

Realized gains and losses for the six months ended June 30, 2002, resulted from various private finance and commercial real estate finance transactions. Realized gains for the six months ended June 30, 2002, primarily resulted from transactions involving three private finance portfolio companies, Aurora Communications, LLC (\$4.9 million), Cumulus Media, Inc. (\$0.5 million) and Alderwoods Group, Inc. (\$0.1 million), the sale of CMBS bonds (\$7.1 million, including a realized gain from the related hedge of \$1.6 million) and one commercial real estate investment (\$1.3 million). For the six months ended June 30, 2002 and 2001, we reversed previously recorded unrealized appreciation totaling \$7.3 million and \$4.0 million, respectively, when gains were realized.

Realized losses for the six months ended June 30, 2002 primarily resulted from transactions involving four private finance portfolio companies, The Loewen Group, Inc. (\$2.7 million), iSolve Incorporated (\$0.9 million), Sure-Tel, Inc. (\$0.5 million) and Soff-Cut Holdings, Inc. (\$0.5 million), and one commercial real estate investment (\$1.1 million). In January 2002, The Loewen Group, Inc. emerged from bankruptcy and as a result, we exchanged our debt securities for new debt securities and publicly traded common stock in the reorganized company, which resulted in a realized loss. The Loewen Group, Inc. changed its name to Alderwoods Group, Inc. For the six months ended June 30, 2002 and 2001, we reversed previously recorded unrealized depreciation totaling \$5.2 million and \$2.2 million, respectively, when losses were realized.

**Unrealized Gains and Losses.** For a discussion of our fair value methodology and how it affects unrealized gains and losses, see "Unrealized Gains and Losses" included in the "Comparison of Three Months Ended June 30, 2002 and 2001."

Net unrealized gains for the six months ended June 30, 2002 were \$24.1 million, which included \$121.2 million of unrealized gains, and \$97.1 million of unrealized losses. Unrealized gains and losses for the six months ended June 30, 2002 included those discussed under the caption "Unrealized Gains and Losses" included in the "Comparison of Three Months Ended June 30, 2002 and 2001." In addition, unrealized gains in the first quarter of 2002 were \$13.8 million related to unrealized appreciation in our investments in WyoTech (\$10.0 million) and Blue Rhino (\$3.8 million). Unrealized losses in the first quarter of 2002 were \$15.9 million primarily related to unrealized depreciation in our investment in Velocita, Inc. (\$10.9 million) and Alderwoods Group, Inc. (\$2.0 million).

**Other Matters.** All per share amounts included in the Management's Discussion and Analysis of Financial Condition and Results of Operations section have been computed using the weighted average shares used to compute diluted earnings per share, which were

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102.9 million and 89.0 million for the six months ended June 30, 2002 and 2001, respectively.

We have elected to be taxed as a regulated investment company under Subchapter M of the Internal Revenue Code of 1986. As long as we qualify as a regulated investment company, we are not taxed on our investment company taxable income or realized capital gains, to the extent that such taxable income or gains are distributed, or deemed to be distributed, to shareholders on a timely basis. Annual tax distributions generally differ from net increase in net assets resulting from operations for the fiscal year due to timing differences in the recognition of income and expenses, returns of capital and net unrealized appreciation or depreciation, which are not included in taxable income.

In order to maintain our status as a regulated investment company, we must, in general, (1) continue to qualify as a business development company; (2) derive at least 90% of our gross income from dividends, interest, gains from the sale of securities and other specified types of income; (3) meet investment diversification requirements as defined in the Internal Revenue Code;

and (4) distribute annually to shareholders at least 90% of our investment company taxable income as defined in the Internal Revenue Code. We intend to take all steps necessary to continue to qualify as a regulated investment company. However, there can be no assurance that we will continue to qualify for such treatment in future years.

## FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

### Cash and Cash Equivalents

At June 30, 2002, and December 31, 2001, we had \$4.3 million and \$0.9 million, respectively, in cash and cash equivalents. We invest otherwise uninvested cash in U.S. government- or agency-issued or guaranteed securities that are backed by the full faith and credit of the United States, or in high quality, short-term repurchase agreements fully collateralized by such securities. Our objective is to manage to a low cash balance and fund new originations with our revolving line of credit.

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### Debt and Other Commitments

We had outstanding debt at June 30, 2002 and December 31, 2001, as follows:

(\$ in millions)		Facility Amount	Amount Outstanding	Annual Interest Cost(1)
<b>At June 30, 2002</b>				
Notes payable and debentures:				
Unsecured long-term notes		\$ 694.0	\$ 694.0	7.8%
Small Business Administration debentures		101.8	94.5	8.2%
Auction rate reset note		75.0	75.0	3.7%
Overseas Private Investment Corporation loan		5.7	5.7	6.6%
Total notes payable and debentures		\$ 876.5	\$ 869.2	7.4%
Revolving line of credit		527.5	139.8	4.1%(2)
Total debt		\$1,404.0	\$1,009.0	7.2%
<b>At December 31, 2001</b>				
Notes payable and debentures:				
Unsecured long-term notes		\$ 694.0	\$ 694.0	7.8%
Small Business Administration debentures		101.8	94.5	7.7%
Auction rate reset note		81.9	81.9	3.9%
Overseas Private Investment Corporation loan		5.7	5.7	6.6%
Total notes payable and debentures		\$ 883.4	\$ 876.1	7.4%
Revolving line of credit		497.5	144.7	3.2%(2)
Total debt		\$1,380.9	\$1,020.8	7.0%

- (1) The annual interest cost includes the cost of commitment fees and other facility fees that are recognized into interest expense over the contractual life of the respective borrowings.
- (2) The current interest rate payable on the revolving line of credit was 4.1% and 3.2% at June 30, 2002 and December 31, 2001, respectively, which excludes the annual cost of commitment fees and other facility fees of \$2.0 million.

**Unsecured Long-Term Notes.** We have issued long-term debt to institutional lenders, primarily insurance companies. The notes have five- or seven-year maturities, with maturity dates beginning in 2003. The notes require payment of interest only semi-annually, and all principal is due upon maturity.

**Small Business Administration Debentures.** We, through our small business investment company subsidiary, have debentures payable to the Small Business Administration with terms of ten years. The notes require payment of interest only semi-annually, and all principal is due upon maturity. Under the small business investment company program, we may borrow up to \$111.7 million from the Small Business Administration. At June 30, 2002, the Small Business Administration has a commitment to lend up to an additional \$7.3 million above the amount outstanding. The commitment expires on September 30, 2005.

**Auction Rate Reset Note.** We have an Auction Rate Reset Senior Note Series A that matures on December 2, 2002 and bears interest at the three-month London Inter-Bank Offered Rate ("LIBOR") plus 1.75%, which adjusts quarterly. Interest is due quarterly, and we, at our option, may pay or defer and capitalize such interest payments. The amount outstanding on the note will increase as interest due is deferred and

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capitalized. As a means to repay the note, we have entered into an agreement with the placement agent of this note to serve as the placement agent on a future issuance of \$75.0 million of debt, equity or other securities in one or more public or private transactions. Alternatively, we may repay the note in cash without conducting a capital raise. If we choose to pay in cash without conducting a capital raise, we will incur additional expense of approximately \$2.1 million.

**Revolving Line of Credit.** As of June 30, 2002, we have a \$527.5 million unsecured revolving line of credit that expires in August 2003, with the right to extend maturity for one additional year at our sole option under substantially similar terms. This facility was increased by \$30.0 million during the first quarter of 2002 from \$497.5 million at December 31, 2001, and may be further expanded up to \$600 million. As of June 30, 2002, \$382.4 million remains unused and available, net of amounts committed for standby letters of credit of \$5.3 million issued under the line of credit facility. The credit facility bears interest at a rate equal to (i) the one-month LIBOR plus 1.25% or (ii) the higher of (a) the Bank of America, N.A. prime rate or (b) the Federal Funds rate plus 0.50%. The credit facility requires monthly payments of interest, and all principal is due upon maturity.

We have various financial and operating covenants required by the revolving line of credit and the notes payable and debentures. These covenants require us to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. Our credit facilities limit

our ability to declare dividends if we default under certain provisions. As of June 30, 2002, we were in compliance with these covenants.

The following table shows our significant contractual obligations as of June 30, 2002.

(\$ in millions) Contractual Obligations	Total	Payments Due By Year					After 2006
		2002	2003	2004	2005	2006	
Notes payable and debentures:							
Unsecured long-term notes	\$ 694.0	\$ —	\$140.0	\$214.0	\$165.0	\$175.0	\$ —
Small Business Administration debentures	94.5	—	—	7.0	14.0	—	73.5
Auction rate reset note	75.0	75.0	—	—	—	—	—
Overseas Private Investment Corporation loan	5.7	—	—	—	—	5.7	—
Revolving line of credit(1)	139.8	—	—	139.8	—	—	—
Operating leases	22.3	1.3	2.6	2.7	2.7	2.6	10.4
Total contractual cash obligations	\$1,031.3	\$76.3	\$142.6	\$363.5	\$181.7	\$183.3	\$83.9

(1) The revolving line of credit expires in August 2003, and may be extended under substantially similar terms for one additional year at our sole option. We assume that we would exercise our option to extend the revolving line of credit, resulting in an assumed maturity of August 2004.

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The following table shows, as of June 30, 2002, our contractual commitments that may have the effect of creating, increasing or accelerating our liabilities.

(\$ in millions) Commitments	Total	Amount of Commitment Expiration Per Year					After 2006
		2002	2003	2004	2005	2006	
Standby letters of credit	\$11.3	\$ —	\$ —	\$ 5.3	\$ —	\$ —	\$6.0
Guarantees	52.2	1.0	—	50.3	0.2	—	0.7
Total commitments	\$63.5	\$1.0	\$ —	\$55.6	\$0.2	\$ —	\$6.7

### Equity Capital and Dividends

Because we are a regulated investment company, we distribute income and require external capital for growth. Because we are a business development company, we are limited in the amount of debt capital we may use to fund our growth, since we are generally required to maintain a minimum ratio of 200% of total assets to total borrowings, or approximately a 1 to 1 debt to equity capital ratio.

To support our growth during the three and six months ended June 30, 2002 and for the year ended December 31, 2001, we raised \$30.0 million, \$49.9 million and \$286.9 million, respectively, in new equity capital through the sale of shares from our shelf registration statement. We issue equity from time to time when we have attractive investment opportunities. In addition, during the

three and six months ended June 30, 2002 and for the year ended December 31, 2001, we raised \$1.5 million, \$3.1 million and \$6.3 million, respectively, in new equity capital through the issuance of shares through our dividend reinvestment plan. At June 30, 2002, total shareholders' equity had increased to \$1,434.5 million.

Our board of directors reviews the dividend rate quarterly, and may adjust the quarterly dividend throughout the year. For the first and second quarters of 2002, the board of directors declared a dividend of \$0.53 and \$0.55 per common share, respectively. The board of directors has recently declared a dividend of \$0.56 per common share for the third quarter of 2002, which will be paid on September 27, 2002 to shareholders of record on September 13, 2002. Dividends are paid based on our taxable income, which includes our taxable interest and fee income as well as taxable net realized capital gains. Our board of directors evaluates whether to retain or distribute capital gains on an annual basis. Our dividend policy allows us to continue to distribute capital gains, but will also allow us to retain gains that exceed a normal capital gains distribution level, and therefore avoid any unusual spike in dividends in any one year. The dividend policy also enables the board of directors to selectively retain gains to support future growth.

We plan to maintain a strategy of financing our business with cash from operations, through borrowings under short- or long-term credit facilities or other debt securities, through asset sales, or through the sale or issuance of new equity capital. Cash flow from operations before new investments was \$258.1 million for the six months ended June 30, 2002, and \$330.8 million for the year ended December 31, 2001. Cash flow from operations before new investments has historically been sufficient to finance our operations.

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We maintain a matched-funding philosophy that focuses on matching the estimated maturities of our loan and investment portfolio to the estimated maturities of our borrowings. We use our short-term credit facilities as a means to bridge to long-term financing, which may or may not result in temporary differences in the matching of estimated maturities. We evaluate our interest rate exposure on an ongoing basis. To the extent deemed necessary, we may hedge variable and short-term interest rate exposure through interest rate swaps or other techniques.

At June 30, 2002, our debt to equity ratio was 0.70 to 1 and our weighted average cost of funds was 7.2%. We had \$382.4 million available under our revolving line of credit. As a result of the receipt of \$77.0 million from the sale of WyoTech on July 1, 2002 and the receipt of \$94.7 million from the sale of CMBS bonds on July 31, 2002, there were no amounts drawn on the revolving line of credit as of August 1, 2002. Availability on the revolving line of credit, net of amounts committed for standby letters of credit issued under the line of credit facility, was \$522.2 million on August 1, 2002. We believe that we have access to capital sufficient to fund our ongoing investment and operating activities.

#### CRITICAL ACCOUNTING POLICIES

Critical accounting policies are those that are both important to the presentation of our financial condition and results of operations and require management's most difficult, complex or subjective



judgments. Our critical accounting policies are those applicable to the valuation of investments and certain revenue recognition matters as discussed below.

**Valuation of Portfolio Investments.** As a business development company, we invest primarily in illiquid securities including debt and equity securities of private companies and non-investment grade CMBS. Our investments are generally subject to restrictions on resale and generally have no established trading market. We value substantially all of our investments at fair value as determined in good faith by the board of directors in accordance with our valuation policy. We determine fair value to be the amount for which an investment could be exchanged in an orderly disposition over a reasonable period of time between willing parties other than in a forced or liquidation sale. Our valuation policy considers the fact that no ready market exists for substantially all of the securities in which we invest. Our valuation policy is intended to provide a consistent basis for establishing the fair value of the portfolio. We will record unrealized depreciation on investments when we believe that an investment has become impaired, including where collection of a loan or realization of an equity security is doubtful. Conversely, we will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and our equity security has also appreciated in value, where appropriate. The value of investments in public securities are determined using quoted market prices discounted for restrictions on resale.

**Loans and Debt Securities.** For loans and debt securities, fair value generally approximates cost unless the borrower's enterprise value or overall financial condition or other factors lead to a determination of fair value at a different amount.

When we receive nominal cost warrants or free equity securities ("nominal cost equity"), we allocate our cost basis in our investment between debt securities and nominal cost equity at the time of origination. At that time, the original issue discount basis of the nominal cost equity is recorded by increasing the cost basis in the equity and decreasing the cost basis in the related debt securities.

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Interest income is recorded on an accrual basis to the extent that such amounts are expected to be collected. For loans and debt securities with contractual payment-in-kind interest, which represents contractual interest accrued and added to the loan balance that generally becomes due at maturity, we will not accrue payment-in-kind interest if the portfolio company valuation indicates that the payment-in-kind interest is not collectible. Loans classified as Grade 4 or Grade 5 assets do not accrue interest. Loan origination fees, original issue discount and market discount are capitalized and then amortized into interest income using the effective interest method. The weighted average yield on loans and debt securities is computed as the (a) annual stated interest rate earned plus the annual amortization of loan origination fees, original issue discount and market discount earned on accruing loans and debt securities, divided by (b) total loans and debt securities at value. The weighted average yield is computed as of the balance sheet date. Prepayment premiums are recorded on loans when received.

**Equity Securities.** Our equity interests in portfolio companies for which there is no liquid public market are valued at fair value based on the enterprise value of the portfolio company, which is determined using various factors, including cash flow from operations of the portfolio company

and other pertinent factors such as recent offers to purchase a portfolio company's securities or other liquidation events. The determined fair values are generally discounted to account for restrictions on resale and minority control positions.

The value of our equity interests in public companies for which market quotations are readily available is based upon the closing public market price on the balance sheet date. Securities that carry certain restrictions on sale are typically valued at a discount from the public market value of the security.

Dividend income is recorded on cumulative preferred equity securities on an accrual basis to the extent that such amounts are expected to be collected and on common equity securities on the record date for private companies or on the ex-dividend date for publicly traded companies.

**Commercial Mortgage-Backed Securities ("CMBS").** CMBS are carried at fair value, which is based upon a discounted cash flow model that utilizes prepayment and loss assumptions based upon historical experience and projected performance, economic factors and the characteristics of the underlying cash flow. Our assumption with regard to discount rate is based upon the yield of comparable securities. We recognize income from the amortization of original issue discount using the effective interest method, using the anticipated yield over the projected life of the investment. Yields are revised when there are changes in estimates of future credit losses, actual losses incurred, or actual and estimated prepayment speeds. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the CMBS from the date the estimated yield is changed. We recognize unrealized appreciation or depreciation on our CMBS as comparable yields in the market change and/or whenever we determine that the value of our CMBS is less than the cost basis due to impairment in the underlying collateral pool.

**Residual Interest.** We value our residual interest from a previous securitization and recognize income using the same accounting policies used for the CMBS. The residual interest is carried at fair value based on discounted estimated future cash flows. We recognize income from the residual interest using the effective interest method. At each reporting date, the effective yield is recalculated and used to recognize income until the next reporting date.

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**Net Realized and Unrealized Gains or Losses.** Realized gains or losses are measured by the difference between the net proceeds from the sale and the cost basis of the investment without regard to unrealized gains or losses previously recognized, and include investments charged off during the year, net of recoveries. Unrealized gains or losses reflect the change in portfolio investment values during the reporting period.

**Fee Income.** Fee income includes fees for diligence, structuring, transaction services, management services and investment advisory services rendered by us to portfolio companies and other third parties. Diligence, structuring and transaction services fees are generally recognized as income when services are rendered or when the related transactions are completed. Management and investment advisory services fees are generally recognized as income as the services are rendered.

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## INVESTMENT CONSIDERATIONS

*Investing in Allied Capital involves a number of significant risks relating to our business and investment objective. As a result, there can be no assurance that we will achieve our investment objective.*

**Investing in private companies involves a high degree of risk.** Our portfolio consists of primarily long-term loans to and investments in private companies. Investments in private businesses involve a high degree of business and financial risk, which can result in substantial losses and accordingly should be considered speculative. There is generally no publicly available information about the companies in which we invest, and we rely significantly on the diligence of our employees and agents to obtain information in connection with our investment decisions. In addition, some smaller businesses have narrower product lines and market shares than their competition, and may be more vulnerable to customer preferences, market conditions or economic downturns, which may adversely affect the return on, or the recovery of, our investment in such businesses.

**Our portfolio of investments is illiquid.** We generally acquire our investments directly from the issuer in privately negotiated transactions. The majority of the investments in our portfolio are typically subject to restrictions on resale or otherwise have no established trading market. We typically exit our investments when the portfolio company has a liquidity event such as a sale, recapitalization or initial public offering of the company. The illiquidity of our investments may adversely affect our ability to dispose of debt and equity securities at times when it may be otherwise advantageous for us to liquidate such investments. In addition, if we were required to liquidate some or all of the investments in the portfolio, the proceeds of such liquidation would be significantly less than the current value of such investments.

**Substantially all of our portfolio investments are recorded at fair value as determined in good faith by our board of directors and, as a result, there is uncertainty regarding the value of our portfolio investments.** At June 30, 2002, \$2,381.0 million, or 93% of our total assets, represented investments recorded at value. Pursuant to the requirements of the 1940 Act, we value substantially all of our investments at fair value as determined in good faith by our board of directors on a quarterly basis. Since there is typically no ready market for the investments in our portfolio, our board of directors determines in good faith the fair value of these investments pursuant to a valuation policy and a consistently applied valuation process.

There is no single standard for determining fair value in good faith. As a result, determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment while employing a consistently applied valuation process for the types of investments we make. Unlike banks, we are not permitted to provide a general reserve for anticipated loan losses; we are instead required by the 1940 Act to specifically value each individual investment and record unrealized depreciation for an investment that we believe has become impaired, including where collection of a loan or realization of an equity security is doubtful. Conversely, we will

record unrealized appreciation if we have an indication that the underlying portfolio company has appreciated in value and, therefore, our security has also appreciated in value, where appropriate. Without a readily ascertainable market value and because of the inherent uncertainty of valuation, the fair value of our investments determined in good faith by the board of directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

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We adjust quarterly the valuation of our portfolio to reflect the board of directors' estimate of the fair value of each investment in our portfolio. Any changes in estimated fair value are recorded in our statement of operations as "Net unrealized gains (losses)."

**Economic recessions or downturns could impair our portfolio companies and harm our operating results.** Many of the companies in which we have made or will make investments may be susceptible to economic slowdowns or recessions. An economic slowdown may affect the ability of a company to engage in a liquidity event. Our non-performing assets are likely to increase and the value of our portfolio is likely to decrease during these periods. These conditions could lead to financial losses in our portfolio and a decrease in our revenues, net income and assets.

Our business of making private equity investments and positioning them for liquidity events also may be affected by current and future market conditions. The absence of an active senior lending environment may slow the amount of private equity investment activity generally. As a result, the pace of our investment activity may slow. In addition, significant changes in the capital markets could have an effect on the valuations of private companies and on the potential for liquidity events involving such companies. This could affect the amount and timing of gains realized on our investments.

**Our borrowers may default on their payments, which may have an effect on our financial performance.** We make long-term unsecured, subordinated loans and invest in equity securities, which may involve a higher degree of repayment risk. We primarily invest in companies that may have limited financial resources and that may be unable to obtain financing from traditional sources. Numerous factors may affect a borrower's ability to repay its loan, including the failure to meet its business plan, a downturn in its industry or negative economic conditions. Deterioration in a borrower's financial condition and prospects may be accompanied by deterioration in any related collateral.

**Our private finance investments may not produce current returns or capital gains.** Private finance investments are typically structured as debt securities with a relatively high fixed rate of interest and with equity features such as conversion rights, warrants or options. As a result, private finance investments are generally structured to generate interest income from the time they are made, and may also produce a realized gain from an accompanying equity feature. We cannot be sure that our portfolio will generate a current return or capital gains.

**Our financial results could be negatively affected if Business Loan Express fails to perform as expected.** Business Loan Express, Inc. is our largest portfolio investment. Our financial

results could be negatively affected if Business Loan Express, as a portfolio company, fails to perform as expected or if government funding for, or regulations related to the Small Business Administration 7(a) Guaranteed Loan Program change. At June 30, 2002, the investment totaled \$251.9 million at value, or 9.8% of total assets.

In addition, as controlling shareholder of Business Loan Express, we have provided an unconditional guaranty to Business Loan Express' senior credit facility lenders in an amount equal to 50% of Business Loan Express' total obligations on its \$124.0 million revolving credit facility. The amount we have guaranteed at June 30, 2002, was \$48.1 million. This guaranty can only be called in the event of a default by Business Loan Express. We have also provided two standby letters of credit in connection with two term loan securitization transactions completed by Business Loan Express in the second quarter of 2002 totaling \$10.6 million.

**Investments in non-investment grade commercial mortgage-backed securities may be illiquid, may have a higher risk of default and may not produce current returns. The**

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commercial mortgage-backed securities in which we invest are not investment grade, which means that nationally recognized statistical rating organizations rate them below the top four investment-grade rating categories (i.e., "AAA" through "BBB"), and are sometimes referred to as "junk bonds." Non-investment grade commercial mortgage-backed securities tend to be less liquid, may have a higher risk of default and may be more difficult to value. Non-investment grade securities usually provide a higher yield than do investment-grade securities, but with the higher return comes greater risk of default. Economic recessions or downturns may cause defaults or losses on collateral securing these securities to increase. Non-investment grade securities are considered speculative, and their capacity to pay principal and interest in accordance with the terms of their issue is not ensured.

**We may not borrow money unless we maintain asset coverage for indebtedness of at least 200% which may affect returns to shareholders.** We must maintain asset coverage for total borrowings of at least 200%. Our ability to achieve our investment objective may depend in part on our continued ability to maintain a leveraged capital structure by borrowing from banks or other lenders on favorable terms. There can be no assurance that we will be able to maintain such leverage. If asset coverage declines to less than 200%, we may be required to sell a portion of our investments when it is disadvantageous to do so. As of June 30, 2002, our asset coverage for senior indebtedness was 256%.

**We borrow money which magnifies the potential for gain or loss on amounts invested and may increase the risk of investing in us.** Borrowings, also known as leverage, magnify the potential for gain or loss on amounts invested and, therefore, increase the risks associated with investing in our securities. We borrow from, and issue senior debt securities to, banks, insurance companies and other lenders. Lenders of these senior securities have fixed dollar claims on our consolidated assets that are superior to the claims of our common shareholders. If the value of our consolidated assets increases, then leveraging would cause the net asset value attributable to our common stock to increase more sharply than it would have had we not leveraged. Conversely, if the

value of our consolidated assets decreases, leveraging would cause net asset value to decline more sharply than it otherwise would have had we not leveraged. Similarly, any increase in our consolidated income in excess of consolidated interest payable on the borrowed funds would cause our net income to increase more than it would without the leverage, while any decrease in our consolidated income would cause net income to decline more sharply than it would have had we not borrowed. Such a decline could negatively affect our ability to make common stock dividend payments. Leverage is generally considered a speculative investment technique.

At June 30, 2002, we had \$1,009.0 million of outstanding indebtedness, bearing a weighted average annual interest cost of 7.2%. In order for us to cover these annual interest payments on indebtedness, we must achieve annual returns on our assets of at least 2.8%.

**Changes in interest rates may affect our cost of capital and net investment income.**

Because we borrow money to make investments, our net investment income before net realized and unrealized gains or losses, or net investment income, is dependent upon the difference between the rate at which we borrow funds and the rate at which we invest these funds. As a result, there can be no assurance that a significant change in market interest rates will not have a material adverse effect on our net investment income. In periods of sharply rising interest rates, our cost of funds would increase, which would reduce our net investment income. We use a combination of long-term and short-term borrowings and equity capital to finance our investing activities. We utilize our short-term credit facilities as a means to bridge to long-term financing. Our long-term fixed-rate

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investments are financed primarily with long-term fixed-rate debt and equity. We may use interest rate risk management techniques in an effort to limit our exposure to interest rate fluctuations. Such techniques may include various interest rate hedging activities to the extent permitted by the 1940 Act.

**We will continue to need additional capital to grow because we must distribute our income.** We will continue to need capital to fund incremental growth in our investments. Historically, we have borrowed from financial institutions and have issued equity securities. A reduction in the availability of new capital could limit our ability to grow. We must distribute at least 90% of our taxable ordinary income, which excludes net realized long-term capital gains, to our shareholders to maintain our regulated investment company status. As a result, such earnings will not be available to fund investment originations. We expect to continue to borrow from financial institutions and sell additional equity securities. If we fail to obtain funds from such sources or from other sources to fund our investments, it could limit our ability to grow, which could have a material adverse effect on the value of our common stock. In addition, as a business development company, we are generally required to maintain a ratio of at least 200% of total assets to total borrowings, which may restrict our ability to borrow in certain circumstances.

**Loss of pass-through tax treatment would substantially reduce net assets and income available for dividends.** We have operated so as to qualify as a regulated investment company under Subchapter M of the Internal Revenue Code of 1986. If we meet source of income, diversification and distribution requirements, we will qualify for effective pass-through tax

treatment. We would cease to qualify for such pass-through tax treatment if we were unable to comply with these requirements. In addition, we may have difficulty meeting the requirement to make distributions to our shareholders because in certain cases we may recognize income before or without receiving cash representing such income. If we fail to qualify as a regulated investment company, we will have to pay corporate-level taxes on all of our income whether or not we distribute it, which would substantially reduce the amount of income available for distribution to our stockholders. Even if we qualify as a regulated investment company, we generally will be subject to a corporate-level income tax on the income we do not distribute. Moreover, if we do not distribute at least 98% of our income, we generally will be subject to a 4% excise tax.

**There is a risk that you may not receive dividends or distributions.** We intend to make distributions on a quarterly basis to our stockholders. We may not be able to achieve operating results that will allow us to make distributions at a specific level or to increase the amount of these distributions from time to time. In addition, due to the asset coverage test applicable to us as a business development company, we may be limited in our ability to make distributions. Also, our credit facilities limit our ability to declare dividends if we default under certain provisions. If we do not distribute a certain percentage of our income annually, we will suffer adverse tax consequences, including possible loss of our status as a regulated investment company. In addition, in accordance with accounting principles generally accepted in the United States of America and tax regulations, we include in income certain amounts that we have not yet received in cash, such as contractual payment-in-kind interest which represents contractual interest added to the loan balance that becomes due at the end of the loan term. The increases in loan balances as a result of contractual payment-in-kind arrangements are included in income in advance of receiving cash payment, and are separately included in the change in accrued or reinvested interest and dividends in our consolidated statement of cash flows. Since we may recognize income before or without receiving cash representing such income, we may have difficulty meeting the requirement to distribute at least 90% of our income to maintain our status as a regulated investment company.

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**We operate in a competitive market for investment opportunities.** We compete for investments with a large number of private equity funds and mezzanine funds, investment banks and other equity and non-equity based investment funds, and other sources of financing, including traditional financial services companies such as commercial banks. Some of our competitors have greater resources than we do. Increased competition would make it more difficult for us to purchase or originate investments at attractive prices. As a result of this competition, sometimes we may be precluded from making otherwise attractive investments.

**We depend on key personnel.** We depend on the continued services of our executive officers and other key management personnel. If we were to lose any of these officers or other management personnel, such a loss could result in inefficiencies in our operations and lost business opportunities.

**Changes in the law or regulations that govern us could have a material impact on us or our operations.** We are regulated by the SEC and the Small Business Administration. In addition, changes in the laws or regulations that govern business development companies, regulated

investment companies, real estate investment trusts, and small business investment companies may significantly affect our business. Any change in the law or regulations that govern our business could have a material impact on us or our operations. Laws and regulations may be changed from time to time, and the interpretations of the relevant laws and regulations also are subject to change.

**Results may fluctuate and may not be indicative of future performance.** Our operating results will fluctuate and, therefore, you should not rely on current or historical period results to be indicative of our performance in future reporting periods. Factors that could cause operating results to fluctuate include, among others, variations in the investment origination volume and fee income earned, variation in timing of prepayments, variations in and the timing of the recognition of realized and unrealized gains or losses, the degree to which we encounter competition in our markets and general economic conditions.

**Our common stock price may be volatile.** The trading price of our common stock may fluctuate substantially. The price of the common stock may be higher or lower than the price you pay for your shares, depending on many factors, some of which are beyond our control and may not be directly related to our operating performance. These factors include the following:

- price and volume fluctuations in the overall stock market from time to time;
- significant volatility in the market price and trading volume of securities of business development companies or other financial services companies;
- volatility resulting from trading in derivative securities related to our common stock including puts, calls, long-term equity anticipation securities, or LEAPs, or short trading positions;
- changes in regulatory policies or tax guidelines with respect to business development companies or regulated investment companies;
- actual or anticipated changes in our earnings or fluctuations in our operating results or changes in the expectations of securities analysts;
- general economic conditions and trends;
- loss of a major funding source; or
- departures of key personnel.

Recently, the trading price of our common stock has been volatile. Due to the continued potential volatility of our stock price, we may be the target of securities litigation

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in the future. Securities litigation could result in substantial costs and divert management's attention and resources from our business. For information about current securities class action lawsuits filed against us, see Note 12 to the financial statements.



### Disclosure Regarding Forward-Looking Statements

Information contained in this Form 10-Q may contain “forward-looking statements” which can be identified by the use of forward-looking terminology such as “may,” “will,” “expect,” “intend,” “anticipate,” “estimate” or “continue” or the negative thereof or other variations or similar words or phrases. The matters described in “Investment Considerations” and certain other factors noted throughout this Form 10-Q constitute cautionary statements identifying important factors with respect to any such forward-looking statements, including certain risks and uncertainties, that could cause actual results to differ materially from those in such forward-looking statements.

Although we believe that the assumptions on which these forward-looking statements are based are reasonable, any of those assumptions could prove to be inaccurate, and as a result, the forward-looking statements based on those assumptions also could be incorrect. Important assumptions include our ability to originate new investments, maintain certain margins and levels of profitability, access the capital markets for debt and equity capital, the ability to meet regulatory requirements and the ability to maintain certain debt to asset ratios. In light of these and other uncertainties, the inclusion of a projection or forward-looking statement in this Form 10-Q should not be regarded as a representation by us that our plans and objectives will be achieved. These risks and uncertainties include those described in “Investment Considerations” and elsewhere in this Form 10-Q. You should not place undue reliance on these forward-looking statements, which apply only as of the date of this Form 10-Q.

#### Item *Quantitative and Qualitative Disclosures About Market Risk* 3.

Our business activities contain elements of risk. We consider the principal types of risk to be fluctuations in interest rates and portfolio valuations. We consider the management of risk essential to conducting our businesses. Accordingly, our risk management systems and procedures are designed to identify and analyze our risks, to set appropriate policies and limits and to continually monitor these risks and limits by means of reliable administrative and information systems and other policies and programs.

As a business development company, we invest primarily in illiquid securities including debt and equity securities of private companies and non-investment grade CMBS. Our investments are generally subject to restrictions on resale and generally have no established trading market. Since there is typically no ready market for the investments in our portfolio, our board of directors determines in good faith the fair value of these investments pursuant to a valuation policy and a consistently applied valuation process. We value substantially all of our investments at fair value as determined in good faith by the board of directors in accordance with our valuation policy. There is no single standard for determining fair value in good faith. As a result, determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment while employing a consistently applied valuation process for the types of investments we make.

We determine fair value to be the amount for which an investment could be exchanged in an orderly disposition over a reasonable period of time between willing parties other than in a forced

or liquidation sale. Our valuation policy considers the fact that no ready market exists for substantially all of the securities in which we invest. Our

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valuation policy is intended to provide a consistent basis for establishing the fair value of the portfolio. We will record unrealized depreciation on investments when we believe that an investment has become impaired, including where collection of a loan or realization of an equity security is doubtful. Conversely, we will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and our equity security has also appreciated in value, where appropriate. The value of investments in public securities are determined using quoted market prices discounted for restrictions on resale. Without a readily ascertainable market value and because of the inherent uncertainty of valuation, the fair value of our investments determined in good faith by the board of directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material. See "Management's Discussion and Analysis of Financial Conditions and Results of Operations — Critical Accounting Policies" and "— Results of Operations — Comparison of Three Months Ended June 30, 2002 and 2001 — Unrealized Gains and Losses."

In addition, the illiquidity of our investments may adversely affect our ability to dispose of loans and securities at times when it may be otherwise advantageous for us to liquidate such investments. In addition, if we were required to liquidate some or all of the investments in the portfolio, the proceeds of such liquidation would be significantly less than the current value of such investments.

Because we borrow money to make investments, our net investment income before net realized and unrealized gains or losses, or net investment income, is dependent upon the difference between the rate at which we borrow funds and the rate at which we invest these funds. As a result, there can be no assurance that a significant change in market interest rates will not have a material adverse effect on our net investment income. In periods of sharply rising interest rates, our cost of funds would increase, which would reduce our net investment income. We use a combination of long-term and short-term borrowings and equity capital to finance our investing activities. We utilize our short-term credit facilities as a means to bridge to long-term financing. Our long-term fixed-rate investments are financed primarily with long-term fixed-rate debt and equity. We may use interest rate risk management techniques in an effort to limit our exposure to interest rate fluctuations. Such techniques may include various interest rate hedging activities to the extent permitted by the 1940 Act. We have analyzed the potential impact of changes in interest rates on interest income net of interest expense. Assuming that the balance sheet were to remain constant and no actions were taken to alter the existing interest rate sensitivity, a hypothetical immediate 1% change in interest rates would have affected the net increase in net assets resulting from operations, or net income, by less than 1% over a one year horizon. Although management believes that this measure is indicative of our sensitivity to interest rate changes, it does not adjust for potential changes in credit quality, size and composition of the assets on the balance sheet and other business developments that could affect net increase in assets resulting from operations, or net income. Accordingly, no assurances can be given that actual results would not differ materially from the potential outcome simulated by this estimate.

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## PART II. OTHER INFORMATION

### Item 1. *Legal Proceedings*

As of August 13, 2002, we are aware of seven class action lawsuits that have been filed in the United States District Court for the Southern District of New York against us, certain of our directors and officers and our former independent auditors, Arthur Andersen LLP, with respect to alleged violations of the securities laws. All of the actions essentially duplicate one another, pleading essentially the same allegations. The complaints filed in the lawsuits allege violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, specifically alleging, among other things, that we misstated the value of certain portfolio investments in our financial statements, which allegedly resulted in the purchase of our common stock by purported class members at artificially inflated prices. Several of the complaints also allege state law claims for common law fraud. The lawsuits seek compensatory and other damages, and costs and expenses associated with the litigation. We believe that each of the lawsuits is without merit, and we intend to defend each of these lawsuits vigorously. While we do not expect these matters to materially affect our financial condition or results of operations, there can be no assurance of any particular outcome.

We also are party to certain other lawsuits in the normal course of business. While the outcome of these legal proceedings cannot at this time be predicted with certainty, we do not expect that these proceedings will have a material effect upon our financial condition or results of operations.

### Item 2. *Changes in Securities and Use of Proceeds*

During the three months ended June 30, 2002, we issued a total of 71,285 shares of common stock under our dividend reinvestment plan pursuant to an exemption from the registration requirements of the Securities Act of 1933. The aggregate offering price for the shares of common stock sold under the dividend reinvestment plan was approximately \$1.5 million.

### Item 3. *Defaults Upon Senior Securities*

Not applicable.

### Item 4. *Submission of Matters to a Vote of Security Holders*

On May 7, 2002, we held our Annual Meeting of Shareholders in Washington, DC. Shareholders voted on three matters; the substance of these matters and the results of the voting of each such matter are described below. There were no broker non-votes for items 1 and 2 below.

1. Election of Directors: Shareholders elected four directors of the Company, who will serve for three years, or until their successors are elected and qualified. Votes were cast as follows:

	For	Withheld
John D. Firestone	92,267,940	958,842
Anthony T. Garcia	92,276,707	950,075
Lawrence I. Hebert	92,267,765	959,017
Laura W. van Roijen	92,263,048	963,735

The following directors are continuing as directors of the Company for their respective terms — William L. Walton, Brooks H. Browne, John I. Leahy, Robert E. Long,

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Warren K. Montouri, Guy T. Steuart II, T. Murray Toomey, Esq., and George C. Williams, Jr.

2. Ratification of the selection of KPMG LLP to serve as independent public accounts for the year ending December 31, 2002. Votes were cast as follows:

For	Against	Abstain
91,908,127	938,936	379,717

3. Shareholders approved an amendment to our Stock Option Plan to increase the number of shares of common stock authorized for issuance under the Stock Option Plan by 13,600,000 shares. Broker non-votes were not included in the tabulation for this matter. Votes were cast as follows:

For	Against	Abstain
42,552,664	14,900,645	1,378,014

## Item 5. Other Information

Not applicable.

## Item 6. Exhibits and Reports on Form 8-K

### (a) List of Exhibits

Exhibit Number	Description
3.1	Restated Articles of Incorporation. <i>(Incorporated by reference to Exhibit a.1 filed with Allied Capital's Post-Effective Amendment No. 2 to registration statement on Form N-2 (File No. 333-67336) filed on March 22, 2002).</i>
3.2	Amended and Restated Bylaws. <i>(Incorporated by reference to Exhibit b. filed with Allied Capital's Post-Effective Amendment No. 2 to registration statement on Form N-2 (File No. 333-67336) filed on March 22, 2002).</i>
4.1	Specimen Certificate of Allied Capital's Common Stock, par value \$0.0001 per share. <i>(Incorporated by reference to Exhibit d. filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).</i>
4.2	Form of debenture between certain subsidiaries of Allied Capital and the U.S. Small Business

- Administration. *(Incorporated by reference to Exhibit 4.2 filed by a predecessor entity to Allied Capital on Form 10-K for the year ended December 31, 1996).*
- 10.1 Dividend Reinvestment Plan, as amended. *(Incorporated by reference to Exhibit e. filed with Allied Capital's registration statement on Form N-2 (File No. 333-87862) filed on May 8, 2002).*
- 10.2 Second Amended and Restated Credit Agreement, dated August 3, 2001. *(Incorporated by reference to Exhibit f.2.g filed with Allied Capital's registration statement on Form N-2 (File No. 333-67336) filed on August 10, 2001).*
- 10.3 Note Agreement, dated as of April 30, 1998. *(Incorporated by reference to Exhibit 10.2 filed with Allied Capital's Form 10-Q for the period ended June 30, 1998).*

Exhibit Number	Description
10.4	Loan Agreement between a predecessor entity to Allied Capital and Overseas Private Investment Corporation, dated April 10, 1995. <i>(Incorporated by reference to Exhibit f.7 filed by a predecessor entity to Allied Capital to Pre-Effective Amendment No. 2 to the registration statement on Form N-2 (File No. 33-64629) filed on January 24, 1996).</i> Letter, dated December 11, 1997, evidencing assignment of Loan Agreement from the predecessor entity of Allied Capital to Allied Capital. <i>(Incorporated by reference to Exhibit 10.3 of Allied Capital's Form 10-K for the year ended December 31, 1997).</i>
10.5	Note Agreement, dated as of May 1, 1999. <i>(Incorporated by reference to Exhibit 10.5 filed with Allied Capital's Form 10-Q for the period ended June 30, 1999).</i>
10.6	Amendment and Consent Agreement, dated December 11, 2000, to the Amended and Restated Credit Agreement, dated May 17, 2000. <i>(Incorporated by reference to Exhibit f.6 filed with Allied Capital's Post-Effective Amendment No. 2 to registration statement on Form N-2 (File No. 333-43534) filed on March 21, 2001).</i>
10.7	Sale and Servicing Agreement, dated as of January 1, 1998, among Allied Capital CMT, Inc., Allied Capital Commercial Mortgage Trust 1998-1, Allied Capital Corporation, LaSalle National Bank and ABN AMRO Bank N.V. <i>(Incorporated by reference to Exhibit f.7.a filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).</i>
10.8	Indenture, dated as of January 1, 1998, between Allied Capital Commercial Mortgage Trust 1998-1 and LaSalle National Bank. <i>(Incorporated by reference to Exhibit f.7.b filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).</i>
10.9	Amended and Restated Trust Agreement, dated January 1, 1998, between Allied Capital CMT, Inc., LaSalle National Bank Inc. and Wilmington Trust Company. <i>(Incorporated by reference to Exhibit f.7.c filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).</i>
10.10	Guaranty, dated as of January 1, 1998, by Allied Capital. <i>(Incorporated by reference to Exhibit f.7.d filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).</i>
10.11	Note Agreement, dated as of November 15, 1999. <i>(Incorporated by reference to Exhibit 10.4a of Allied Capital's Form 10-K for the year ended December 31, 1999).</i>
10.12	Note Agreement, dated as of October 15, 2000. <i>(Incorporated by reference to Exhibit 10.4b filed with Allied Capital's Form 10-Q for the period ended September 30, 2000).</i>
10.13	Note Agreement, dated as of October 15, 2001. <i>(Incorporated by reference to Exhibit f.10 filed with Allied Capital's Post-Effective Amendment No. 1 to registration statement on Form N-2 (File No. 333-67336) filed on November 14, 2001).</i>

Exhibit Number	Description
10.14	Auction Rate Reset Note Agreement, dated as of August 31, 2000, between Allied Capital and Intrepid Funding Master Trust; Forward Issuance Agreement, dated as of August 31, 2000, between Allied Capital and Banc of America Securities LLC; Remarketing and Contingency Purchase Agreement, dated as of August 31, 2000, between Allied Capital and Banc of America Securities LLC. <i>(Incorporated by reference to Exhibit f.12 filed with Allied Capital's Pre-Effective Amendment No. 1 to registration statement on Form N-2 (File No. 333-43534) filed on September 12, 2000).</i>
10.15	Control Investor Guaranty Agreement, dated as of March 28, 2001, between Allied Capital and Fleet National Bank and Business Loan Express, Inc. <i>(Incorporated by reference to Exhibit f.14 filed with Allied Capital's Post-Effective Amendment No. 3 to registration statement on Form N-2 (File No. 333-43534) filed on May 15, 2001).</i>
10.16	Amended and Restated Deferred Compensation Plan, dated December 30, 1998. <i>(Incorporated by reference to Exhibit 10.11 of Allied Capital's Form 10-K for the year ended December 31, 1998).</i>
10.17	Amendment to Deferred Compensation Plan, dated October 18, 2000. <i>(Incorporated by reference to Exhibit i.2.a filed with Allied Capital's Post-Effective Amendment No. 1 to registration statement on Form N-2 (File No. 333-43534) filed on January 19, 2001).</i>
10.18	Amended and Restated Deferred Compensation Plan, dated May 15, 2001. <i>(Incorporated by reference to Exhibit i.2.b filed with Allied Capital's Post-Effective Amendment No. 1 to registration statement on Form N-2 (File No. 333-67336) filed on November 14, 2001).</i>
10.19	Amended Stock Option Plan. <i>(Incorporated by reference to Exhibit A of Allied Capital's definitive proxy statement for Allied Capital's 2002 Annual Meeting of Stockholders filed on April 3, 2002).</i>
10.20	Allied Capital Corporation 401(k) Plan, dated September 1, 1999. <i>(Incorporated by reference to Exhibit 4.4 filed with Allied Capital's registration statement on Form S-8 (File No. 333-88681) filed on October 8, 1999).</i>
10.21	Amendment to Allied Capital Corporation 401(k) Plan, dated December 31, 2000. <i>(Incorporated by reference to Exhibit i.5.a filed with Allied Capital's Post-Effective Amendment No. 1 to registration statement on Form N-2 (File No. 333-43534) filed on January 19, 2001).</i>
10.22	Employment Agreement, dated June 15, 2000, between Allied Capital and William L. Walton. <i>(Incorporated by reference to Exhibit f.9 filed with Allied Capital's registration statement on Form N-2 (File No. 333-43534) filed on August 11, 2000).</i>
10.23	Employment Agreement, dated June 15, 2000, between Allied Capital and Joan M. Sweeney. <i>(Incorporated by reference to Exhibit f.10 filed with Allied Capital's registration statement on Form N-2 (File No. 333-43534) filed on August 11, 2000).</i>
10.24	Employment Agreement, dated June 15, 2000, between Allied Capital and John M. Scheurer. <i>(Incorporated by reference to Exhibit f.10 filed with Allied Capital's Post-Effective Amendment No. 2 to registration statement on Form N-2 (File No. 333-43534) filed on March 21, 2001).</i>

Exhibit Number	Description
10.25	Form of Custody Agreement with Riggs Bank N.A. <i>(Incorporated by reference to Exhibit j.1 filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).</i>
10.26	Form of Custody Agreement with LaSalle National Bank. <i>(Incorporated by reference to Exhibit j.2 filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).</i>
10.27	Custodian Agreement with LaSalle National Bank Association dated July 9, 2001. <i>(Incorporated by reference to Exhibit j.3 filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).</i>

- by reference to Exhibit 1.5 filed with Allied Capital's registration statement on Form N-2 (File No. 333-67336) filed on August 10, 2001).
- 10.28 Code of Ethics. (Incorporated by reference to Exhibit 1.5 filed with Allied Capital's Pre-Effective Amendment No. 1 to the registration statement on Form N-2 (File No. 333-43534) on September 12, 2000).
- 15\* Letter regarding Unaudited Interim Financial Information
- 99.1\* Certification of Chief Executive Officer Pursuant to 18 U.S.C. 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 99.2\* Certification of Chief Financial Officer Pursuant to 18 U.S.C. 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

\* Filed herewith.

### (b) Reports on Form 8-K.

On April 3, 2002, we filed a Form 8-K reporting that we had selected KPMG LLP to serve as our independent public accountants for the fiscal year December 31, 2002 and dismissed Arthur Andersen LLP as our public accountants effective upon completion of the December 31, 2001 audit.

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## SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunder duly authorized.

ALLIED CAPITAL CORPORATION

(Registrant)

/s/ WILLIAM L. WALTON

Chairman and Chief Executive Officer

Dated: August 14, 2002

/s/ PENNI F. ROLL

Chief Financial Officer

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Exhibit 15

The Board of Directors and Shareholders  
Allied Capital Corporation and Subsidiaries:

Re: Registration Statement Nos. 333-45525 and 333-13584

Ladies and Gentlemen:

With respect to the subject registration statements, we acknowledge our awareness of the use therein of our report dated July 22, 2002 (except as to Notes 12 and 13 which are as of August 13, 2002 and July 31, 2002, respectively) related to our review of interim financial information.

Pursuant to Rule 436 under the Securities Act of 1933 (the Act), such report is

not considered part of a registration statement prepared or certified by an accountant, or a report prepared or certified by an accountant within the meaning of Sections 7 and 11 of the Act.

/s/ KPMG LLP

Washington, D.C.  
August 14, 2002

Exhibit 99.1

**Certification of Chief Executive Officer Pursuant to 18 U.S.C. 1350,  
As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**

In connection with the Quarterly Report on Form 10-Q for the period ended June 30, 2002 (the "Report") of Allied Capital Corporation (the "Registrant"), as filed with the Securities and Exchange Commission on the date hereof, I, William L. Walton, the Chief Executive Officer of the Registrant, certify, to the best of my knowledge, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Registrant.

/s/ William L. Walton  
Name: William L. Walton  
Date: August 14, 2002

Exhibit 99.2

**Certification of Chief Financial Officer Pursuant to 18 U.S.C. 1350,  
As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**

In connection with the Quarterly Report on Form 10-Q for the period ended June 30, 2002 (the "Report") of Allied Capital Corporation (the "Registrant"), as filed with the Securities and Exchange Commission on the date hereof, I, Penni F. Roll, the Chief Financial Officer of the Registrant, certify, to the best of my knowledge, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Registrant.

/s/ Penni F. Roll  
Name: Penni F. Roll  
Date: August 14, 2002



**EXHIBIT C**

**Debtors' Joint Plan of Reorganization**

IN THE UNITED STATES BANKRUPTCY COURT  
FOR THE DISTRICT OF MARYLAND  
Greenbelt Division

In re:	)	Chapter 11
	)	
Startec Global Communications Corporation,	)	Case No. 01-25013 (DK)
Startec Global Operating Company, and	)	Case No. 01-25009 (DK)
Startec Global Licensing Company,	)	Case No. 01-25010 (DK)
	)	
Debtors.	)	Jointly Administered Under
	)	Case No. 01-25013 (DK)

DEBTORS' JOINT PLAN OF REORGANIZATION

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Dated: June 14, 2002

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## EXHIBITS

EXHIBIT A (Terms of Modified Debt)
EXHIBIT B (Form of Warrant Agreement)
EXHIBIT C (Form of Holdings Certificate of Incorporation)
EXHIBIT D (Terms of Senior Executive Employment Agreements)
EXHIBIT E (Schedule of Assumed Contracts)
EXHIBIT F (Initial Board of Reorganized Holdings)



Pursuant to chapter 11 of title 11 of the United States Code, 11 U.S.C. §§ 1101 *et seq.*, Startec Global Communications Corporation, Startec Global Operating Company, and Startec Global Licensing Company, each a Delaware corporation, debtors and debtors in possession in the above-captioned and numbered jointly-administered chapter 11 cases, hereby respectfully propose the following Joint Plan of Reorganization dated June 14, 2002:

**ARTICLE ONE**  
**DEFINITIONS AND INTERPRETATIONS**

1.1. **Definitions.** Unless the context requires otherwise, the following words and phrases shall have the meanings set forth below:

1.1.1. **Administrative Expense:** A right to payment from the Consolidated Debtors constituting a cost or expense of administration of the Chapter 11 Cases of the Consolidated Debtors arising on or after the Filing Date and before the Effective Date under section 503(b) of the Bankruptcy Code that is entitled to priority under section 507(a)(1) of the Bankruptcy Code, including any actual and necessary costs and expenses of preserving one or more of the Consolidated Debtors' Estates, any actual and necessary costs and expenses of operating one or more of the Consolidated Debtors' businesses, and any fees or charges assessed against one or more of the Estates of the Consolidated Debtors under section 1930 of chapter 123 of title 28 of the United States Code.

1.1.2. **Allied:** Allied Capital Corporation, a Maryland corporation.

1.1.3. **Allied Other Secured Claim:** The Claim of Allied arising from that certain promissory note dated April 13, 2001 in the principal amount of \$10,000,000, secured by a Lien on all cash and accounts of the Subsidiary Debtors.

1.1.4. **Allied Releasees:** Allied and its current and former officers, directors, shareholders, employees, consultants, attorneys and other representatives.

1.1.5. **Allied Unsecured Claim:** The Claim of Allied arising from that certain promissory note dated April 13, 2001 in the principal amount of \$10,000,000, not secured by a Lien on any property of any of the Debtors.

1.1.6. **Allied Tranche A Claim:** The Claim of Allied under the "Tranche A" debtor-in-possession loan in the principal amount of \$16,315,000 made to the Debtors pursuant to, and as defined in, the DIP Facility Agreement.

1.1.7. **Allied Tranche B Claim:** The Claim of Allied under the "Tranche B" debtor-in-possession loan in the principal amount of \$7,500,000 made to the Debtors pursuant to, and as defined in, the DIP Facility Agreement.

1.1.8. **Allowance Date:** (a) With respect to a Claim or Administrative Expense Allowed pursuant to Final Order, the date on which such order becomes a Final Order; (b) with respect to a Claim or Administrative Expense Allowed under this Plan, the Effective Date; (c) with respect to a Claim or Administrative Expense Allowed by agreement of the Debtors in

accordance with Section 11.2 of this Plan, the date fixed in the agreement as the Allowance Date (or if no such date is specified, the date of the agreement); and (d) with respect to a Claim or Administrative Expense Allowed because no objection is filed thereto by the Claims Objection Deadline or other applicable deadline, the first Business Day after such deadline.

1.1.9. Allowed: With respect to Pre-Petition Claims, (a) any Claim against a Debtor for which a Proof of Claim has been Filed by the Bar Date, (b) any Claim that has been or is hereafter listed in the Schedules as neither disputed, contingent or unliquidated, and for which no Proof of Claim has been Filed by the Bar Date, or (c) any Claim allowed pursuant to this Plan, by agreement of the Debtors in accordance with Section 11.2 of this Plan, or by Final Order of the Bankruptcy Court; provided, however, that with respect to any Claim described in clauses (a) or (b) above, such Claim shall be Allowed only if (i) no objection to the allowance thereof has been interposed by the Claims Objection Deadline or within such other applicable period of time fixed by this Plan, the Bankruptcy Code, the Bankruptcy Rules or the Bankruptcy Court or (ii) such an objection has been interposed, but the objection has been withdrawn or the Claim shall have been allowed by a Final Order or by agreement of the Debtors in accordance with Section 11.2 of this Plan (but only if such allowance was not solely for the purpose of voting to accept or reject this Plan). With respect to Administrative Expenses, (a) any Professional Fee Claim allowed by Final Order of the Bankruptcy Court, or (b) any other Administrative Expense that is not disputed by the Debtors or is disputed by the Debtors and is allowed by agreement of the Debtors in accordance with Section 11.2 of this Plan or by Final Order of the Bankruptcy Court. Except as otherwise specified in this Plan or a Final Order of the Bankruptcy Court, or as otherwise required under applicable law with respect to an Administrative Expense, the amount of an Allowed Claim shall not include interest on such Claim accruing from and after the Filing Date.

1.1.10. Allowed Claim: A Claim against one of more of the Consolidated Debtors that has been Allowed.

1.1.11. Allowed . . . Claim: An Allowed Claim of the type described.

1.1.12. Alternative Plan: In the event that the Court declines to substantively consolidate the Estate of Holdings with the Estates of the Subsidiary Debtors in the manner set forth in Section 9.9(a) or otherwise, or this Plan is not otherwise confirmed as to Holdings, this Plan as applied only to Operating and Licensing.

1.1.13. Applicable Rate: A fixed annual rate of interest to be determined by the Bankruptcy Court or otherwise agreed to by the Reorganized Debtors and the relevant Creditor.

1.1.14. Assets: Any and all real or personal property of any nature, Including any real estate, buildings, structures, improvements, privileges, rights, easements, leases, subleases, licenses, goods, materials, supplies, furniture, fixtures, equipment, work in process, accounts, chattel paper, cash, deposit accounts, reserves, deposits, contractual rights, intellectual property rights, claims, Causes of Action and any other general intangibles of a Consolidated Debtor, as the case may be, of any nature whatsoever, Including all property of the Estates of the Consolidated Debtors pursuant to section 541 of the Bankruptcy Code.

1.1.15. Avaya: Avaya Canada Corp., a corporation organized under the laws of Canada.

1.1.16. Avaya Claim: The Claim in the amount of CDN \$61,186.10 of Avaya arising from that certain Master Procurement Agreement by and between Avaya and Holdings, dated February 14, 2001, the schedules thereto and the purchase orders executed in connection therewith.

1.1.17. Avaya Equipment: The PBX equipment owned by Holdings located in the State of Maryland and Vancouver, Canada, that secures the Avaya Secured Claim.

1.1.18. Avaya Secured Claim: That portion of the Avaya Claim that is secured by a Lien on the Avaya Equipment and that is a Secured Claim, as provided in Section 6.2.4 of this Plan.

1.1.19. Ballot: The form of ballot accompanying the Disclosure Statement provided to each Holder of a Claim entitled to vote to accept or reject this Plan.

1.1.20. Bankruptcy Code: The Bankruptcy Reform Act of 1978, as amended and codified in title 11 of the United States Code, 11 U.S.C. §§ 101 et seq., and applicable portions of titles 18 and 28 of the United States Code.

1.1.21. Bankruptcy Court: The division of the United States Bankruptcy Court for the District of Maryland (Greenbelt Division) having jurisdiction over the Chapter 11 Cases or any other court having jurisdiction over the Chapter 11 Cases or the applicable proceedings therein.

1.1.22. Bankruptcy Rules: The Federal Rules of Bankruptcy Procedure, as amended from time to time, as applicable to the Chapter 11 Cases, promulgated under 28 U.S.C. § 2075 and as supplemented by the Local Rules of the Bankruptcy Court.

1.1.23. Bar Date: With respect to all Creditors other than Governmental Units, (a) April 8, 2002, the date fixed by order of the Bankruptcy Court by which any Proof of Claim must be Filed, or (b) such other date by which a Proof of Claim must be Filed as fixed by Final Order of the Bankruptcy Court, the Bankruptcy Code, or the Bankruptcy Rules. With respect to Governmental Units, (a) June 12, 2002 or (b) such other date by which a Proof of Claim must be filed as fixed by Final Order of the Bankruptcy Court, the Bankruptcy Code, or the Bankruptcy Rules.

1.1.24. Board: The board of directors of a Debtor or a Reorganized Debtor, as applicable.

1.1.25. By-Laws: The By-Laws of a Debtor in effect as of the Filing Date.

1.1.26. Business Day: Any day, other than a Saturday, Sunday or legal holiday (as defined in Bankruptcy Rule 9006(a)).

1.1.27. Cash: United States currency, a certified check, a cashier's check or a wire transfer of good funds from any source, or a check drawn on a domestic bank by a Debtor, a Reorganized Debtor or other Entity making any distribution under this Plan.

1.1.28. Catch-up Distribution Date: The six (6) month anniversary of the Effective Date and, if necessary, each six (6) month anniversary thereafter.

1.1.29. Cause of Action: Any action, cause of action, suit, account, controversy, agreement, promise, right to legal remedies, right to equitable remedies, right to payment, or claim, whether known or unknown, reduced to judgment, not reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, secured, unsecured and whether asserted or assertable directly or derivatively, in law, equity or otherwise.

1.1.30. Chapter 11 Cases: The cases under chapter 11 of the Bankruptcy Code, commenced by Holdings, Operating and Licensing in the Bankruptcy Court on December 14, 2001.

1.1.31. CIT: CIT Communications Finance Corporation, a Delaware corporation.

1.1.32. CIT Claim: The Claim in the amount of \$643,931.01 by CIT arising from its pre-petition capital equipment leases with Operating.

1.1.33. CIT Equipment: The Definity G3R manufactured by Lucent Technologies, Inc. and located in the State of Maryland that secures the CIT Claim.

1.1.34. CIT Secured Claim: That portion of the CIT Claim that is secured by a Lien on the CIT Equipment and that is a Secured Claim as provided in Section 6.2.6 of the Plan.

1.1.35. Claim: A claim (as defined in section 101(5) of the Bankruptcy Code) against any Consolidated Debtor, whether or not asserted, Including: (a) any right to payment from a Consolidated Debtor whether or not such right is reduced to judgment, liquidated, unliquidated, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured; or (b) any right to an equitable remedy for breach of performance if such performance gives rise to a right of payment from a Consolidated Debtor, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured or unsecured.

1.1.36. Claims Objection Deadline: As to any Pre-Petition Claim, the date that is (90) days after the Effective Date or ninety (90) days after the Filing of the Proof of Claim for such Claim, whichever is later, or such other date determined by the Bankruptcy Court by Final Order.

1.1.37. Class: A class of Claims or Equity Interests designated pursuant to this Plan.

1.1.38. Committee Releasees: Each member, consultant, attorney, accountant, financial advisor or other representative of the Creditors' Committee.

1.1.39. Confirmation: The entry of the Confirmation Order, subject to all conditions specified in Section 13.1 of this Plan having been satisfied or waived by the Debtors.

1.1.40. Confirmation Date: The date upon which the Confirmation Order is entered by the Bankruptcy Court on its docket, within the meaning of Bankruptcy Rules 5003 and 9021.

1.1.41. Confirmation Hearing: The hearing held by the Bankruptcy Court pursuant to section 1128(a) of the Bankruptcy Code with respect to the confirmation of this Plan pursuant to section 1129 of the Bankruptcy Code.

1.1.42. Confirmation Order: The order of the Bankruptcy Court confirming this Plan pursuant to section 1129 of the Bankruptcy Code.

1.1.43. Consolidated Debtors:

- (a) If the Consolidated Plan is confirmed, the Debtors; or
- (b) If the Alternative Plan is confirmed, the Subsidiary Debtors only.

1.1.44. Consolidated Plan: In the event that the Court substantively consolidates the Estate of Holdings with the Estates of the Subsidiary Debtors in the manner set forth in Section 9.9(a) or otherwise, or this Plan is otherwise confirmed as to all Debtors, this Plan as applied to Holdings, Operating and Licensing.

1.1.45. Consummation: The performance of the acts necessary for the effectiveness of this Plan as of the Effective Date.

1.1.46. Convenience Class: All Holders of General Unsecured Claims (a) whose General Unsecured Claims, in the aggregate for each such Holder, are Allowed in an amount not in excess of \$20,000, or (b) who elects, on a Ballot timely submitted to accept or reject this Plan, to reduce their Claims, in the aggregate for each such Holder, to \$20,000 and to exchange and release such reduced Allowed Claim for an Allowed Convenience Class Claim of the same reduced amount; provided, however, the Convenience Class shall not include any of the Holders of Claims covered by clause (b) above if the inclusion of such Holders of Claims in the Convenience Class would cause the aggregate distribution to the Convenience Class under Section 6.3.3 of this Plan to (or otherwise such aggregate distribution would) exceed \$300,000, or such higher aggregate distribution amount as the Debtors elect.

1.1.47. Creditor: Any Entity that is a Holder of a Pre-Petition Claim against a Debtor.

1.1.48. Creditors' Committee: The official committee of unsecured Creditors appointed in these Chapter 11 Cases pursuant to section 1102(a) of the Bankruptcy Code on January 10, 2002, as the same may be constituted from time to time.

1.1.49. Debtor Releasees: The Consolidated Debtors' current and former officers, directors, shareholders, employees, consultants, attorney, accountants, financial advisors

and other representatives, but excluding any former officers, directors, shareholders, employees, consultants, attorney, accountants, financial advisors and other representatives as to whom any of the Debtors are on the opposite side in ongoing litigation (either as plaintiff or defendant) other than relating to any Proof of Claim or objection to a Proof of Claim filed in Bankruptcy Court.

1.1.50. Debtors: Holdings, Operating and Licensing.

1.1.51. DIP Facility Agreement: The postpetition loan facility agreement, dated as of December 17, 2001 between the Debtors and Allied, providing debtor-in-possession financing in the aggregate principal amount of \$23,815,000, as approved by the Final DIP Order.

1.1.52. Disallowed Claim: A Pre-Petition Claim, or any portion thereof, that (a) has been disallowed by a Final Order of the Bankruptcy Court (or by agreement of the Holder of the Claim to withdraw or treat such Claim or any portion thereof as disallowed), or (b) has not been Scheduled by the Debtor or is Scheduled at zero or as contingent, disputed or unliquidated and as to which the Bar Date has passed but no Proof of Claim has been filed or deemed timely filed with the Bankruptcy Court pursuant to either the Bankruptcy Code or any Final Order of the Bankruptcy Court.

1.1.53. Disclosure Statement: The Debtors' Joint Disclosure Statement describing this Plan, as amended, supplemented, or modified from time to time that is prepared and distributed in accordance with the Bankruptcy Code and Bankruptcy Rules and other applicable law.

1.1.54. Disputed . . . Claim: A Pre-Petition Claim, or any portion thereof, of the type described that is neither an Allowed Claim nor a Disallowed Claim.

1.1.55. Distribution Record Date: The Voting Deadline, as set forth in the Disclosure Statement.

1.1.56. Effective Date: The first Business Day on or after the Confirmation Date on which (a) no stay of the Confirmation Order is in effect (which date may be before the expiration of the 10-day period specified in Bankruptcy Rule 3020(e) if so requested by the Reorganized Debtors and ordered by the Bankruptcy Court); and (b) all conditions to the effectiveness of this Plan and Consummation specified in Section 13.2 hereof have been satisfied or waived, or such later date as the Debtors may determine prior to the entry of the Confirmation Order.

1.1.57. Eligible Employees: Those employees of the Reorganized Debtors eligible to receive Employee Incentive Options and/or to participate in the Employee Incentive Plan, as determined by the Board of Reorganized Holdings on or before the Effective Date.

1.1.58. Employee Incentive Options: Options to purchase up to 5,250,000 shares of New Common Stock, which options shall be issued on or as soon as practicable after the Effective Date to Eligible Employees of the Reorganized Debtors pursuant to the terms and conditions of the Employee Incentive Plan, as follows: 3,500,000 of the Employee Incentive Options shall be exercisable at \$.40 per share, and 1,750,000 of the Employee Incentive Options shall be exercisable at \$.79 per share. The Employee Incentive Options will vest as follows: one-

third shall vest on the Effective Date; one-third shall vest on the first anniversary of the Effective Date; and one-third shall vest on the second anniversary of the Effective Date.

1.1.59. Employee Incentive Plan: The equity incentive plan, which will be established on the Effective Date for Eligible Employees of the Reorganized Debtors pursuant to which, among other things, such Eligible Employees will be issued the Employee Incentive Options.

1.1.60. Entity or Entities: One or more entities as defined in section 101(15) of the Bankruptcy Code.

1.1.61. Equity Interest: Any equity interest in a Debtor, including shares of common stock and rights, options, warrants, calls, subscriptions or other similar rights or agreements, commitments or outstanding securities obligating a Debtor to issue, transfer or sell any shares of capital stock of a Debtor.

1.1.62. Estate: The estate of each Debtor established pursuant to section 541 of the Bankruptcy Code upon the commencement of its respective Chapter 11 Case.

1.1.63. File or Filed: File or filed with the Bankruptcy Court in the Chapter 11 Cases.

1.1.64. Filing Date: December 14, 2001, which was the date on which each of the Debtors Filed a voluntary petition for relief commencing the Chapter 11 Cases.

1.1.65. Final Decree: The decree contemplated under Bankruptcy Rule 3022.

1.1.66. Final DIP Order: The Final Order Pursuant to Section 364 of the Bankruptcy Code and Bankruptcy Rule 4001 Authorizing Postpetition Financing, Granting Secured, Superpriority Claims and Liens, Authorizing and Approving the Use of Cash Collateral and Granting Adequate Protection and Other Relief, entered by the Bankruptcy Court in the Chapter 11 Cases on April 1, 2002, as it may be amended from time to time.

1.1.67. Final Order: An order, ruling or judgment of the Bankruptcy Court or any other court of competent jurisdiction as to which the time to appeal, petition for certiorari, or move for reargument or rehearing has expired and as to which no appeal, petition for certiorari, or other proceedings for reargument or rehearing shall then be pending, or as to which any right to appeal, petition for certiorari, reargue, or rehear shall have been waived in writing in form and substance satisfactory to the Debtors or, on and after the Effective Date, the Reorganized Debtors or, in the event that an appeal, writ of certiorari, or reargument or rehearing thereof has been sought, such order of the Bankruptcy Court or other court of competent jurisdiction shall have been determined by the highest court to which such order was appealed, or certiorari, reargument or rehearing shall have been denied and the time to take any further appeal, petition for certiorari or move for reargument or rehearing shall have expired; provided, however, the possibility that a motion under Rule 59 or Rule 60 of the Federal Rules of Civil Procedure, or any analogous rule under the Bankruptcy Rules, may be Filed with respect to such order shall not cause such order not to be a Final Order.

- 1.1.68. GE Capital: GE Capital Corporation, a Delaware corporation.
- 1.1.69. GE Capital Claim: Those Claims in the aggregate amount of \$641,736.46 by GE Capital arising from its pre-petition capital equipment leases with Operating.
- 1.1.70. GE Capital Equipment: The calling card platform and ascend telecommunications equipment, located in the States of California, Florida, Maryland and New York, that secures the GE Capital Secured Claim.
- 1.1.71. GE Capital Secured Claim: That portion of the GE Capital Claim that is secured by a Lien on the GE Capital Equipment and that is a Secured Claim as provided in Section 6.2.5 of this Plan
- 1.1.72. General Unsecured Claim: Any Claim against any of the Consolidated Debtors that is not an Administrative Expense, a Priority Tax Claim, an Other Priority Claim, the NTFC Claim, the Allied Tranche A Claim, the Allied Tranche B Claim, the Allied Other Secured Claim, the Avaya Claim, the CIT Claim, the GE Capital Claim, the Heller Claim, a Miscellaneous Secured Claim, the Allied Unsecured Claim, a Pre-Petition Note Claim, an Intercompany Claim, or a Subordinated Claim.
- 1.1.73. Governmental Unit: A government unit as defined in section 101(27) of the Bankruptcy Code.
- 1.1.74. Heller: GE Capital, in its capacity as successor in interest to Heller Financial Leasing, Inc. and UniCapital Corporation.
- 1.1.75. Heller Claim: The Claim in the amount of \$1,508,099.11 by Heller arising from its pre-petition capital equipment leases with Operating.
- 1.1.76. Heller Equipment: The equipment described in pre-petition capital equipment leases between Heller and Operating securing the Heller Secured Claim.
- 1.1.77. Heller Secured Claim: That portion of the Heller Claim that is secured by a Lien on the Heller Equipment and that is a Secured Claim as provided in Section 6.2.5 of this Plan.
- 1.1.78. Holder or Holders: One or more Entities holding a right to payment of an Administrative Expense, a Claim or Equity Interest.
- 1.1.79. Holdings: Startec Global Communications Corporation, a Delaware corporation.
- 1.1.80. Impaired: With respect to a Claim, Interest, Class of Claims or Class of Interests, a Claim, Interest, Class of Claims or Class of Interests that is impaired within the meaning of section 1124 of the Bankruptcy Code.
- 1.1.81. Including: Including, but not limited to.



1.1.82. Indenture: The Indenture, dated as of May 21, 1998, as amended, between Holdings, as issuer and the Indenture Trustee pursuant to which the Pre-Petition Notes were issued.

1.1.83. Indenture Trustee: First Union National Bank, as indenture trustee under the Indenture, or its duly appointed successor (if any).

1.1.84. Instrument: Any share of stock, security, promissory note or other "Instrument" within the meaning of that term as defined in section 9-102(47) of the Uniform Commercial Code.

1.1.85. Intercompany Claims:

- (a) If the Consolidated Plan is confirmed, all Intercompany Holdings Claims and Intercompany Subsidiary Claim, or
- (b) If the Alternative Plan is confirmed, all Intercompany Subsidiary Claims and all Intercompany Holdings Claims covered by clause (a) of Section 1.1.86 of this Plan, but not any Intercompany Holdings Claims covered by clause (b) of such Section.

1.1.86. Intercompany Holdings Claims: All Claims (a) held by Holdings against any Subsidiary Debtor, Including all Claims arising as a result of advances made by Holdings to any Subsidiary Debtor, or (b) held by any Subsidiary Debtor against Holdings, Including all Claims arising as a result of advances made by any Subsidiary Debtor to Holdings.

1.1.87. Intercompany Subsidiary Claims: All Claims held by a Subsidiary Debtor against another Subsidiary Debtor, Including Claims arising as a result of advances made by a Subsidiary Debtor to another Subsidiary Debtor.

1.1.88. Lien or Liens: Any charge against or interest in property to secure payment or performance of a claim, debt, or obligation.

1.1.89. Licensing: Startec Global Licensing Company, a Delaware corporation.

1.1.90. Miscellaneous Secured Claim: Any Claim, other than the Allied Tranche A Claim, the Allied Tranche B Claim, the Allied Other Secured Claim, the NTFC Claim, the Avaya Secured Claim, the CIT Secured Claim, the GE Capital Secured Claim, or the Heller Secured Claim, that is a Secured Claim.

1.1.91. Modified Allied Secured Note: The secured promissory note issued to Allied under the DIP Facility Agreement, modified to have the principal amount of \$7,500,000, as such amount may be increased pursuant to Section 9.2 or reduced pursuant to Section 9.9(c) of this Plan, payable to Allied by the Reorganized Debtors and, to the extent they are not prohibited under applicable insolvency law from becoming liable under such notes, the Non-Debtor Subsidiaries, jointly and severally, which note shall be subject to the Post Reorganization Credit Agreement and shall have the terms set forth in Exhibit A hereto.

1.1.92. Modified NTFC Junior Note: A promissory note in the principal amount of \$8,000,000 payable to NTFC by the Reorganized Debtors and, to the extent they are not prohibited under applicable insolvency law from becoming liable under such notes, the Non-Debtor Subsidiaries, which note shall be subject to the Post Reorganization Credit Agreement and shall have the terms set forth in Exhibit A hereto.

1.1.93. Modified NTFC Secured Note: A secured promissory note in the principal amount of \$27,500,000, payable to NTFC by the Reorganized Debtors and, to the extent they are not prohibited under applicable insolvency law from becoming liable under such notes, the Non-Debtor Subsidiaries, which note shall be subject to the Post Reorganization Credit Agreement and shall have the terms set forth in Exhibit A hereto.

1.1.94. Mukunda Claim: The Pre-Petition Claim of Ram Mukunda, as reflected in the Proof of Claim Filed April 8, 2002 against the Consolidated Debtors.

1.1.95. Mukunda Note: That certain promissory note dated October 8, 1998, as amended, in the principal amount of \$1,062,016.88, between Ram Mukunda, as maker, and Operating, as payee.

1.1.96. Mukunda Note and Claim Agreement: An agreement to be executed by and between the Reorganized Debtors and Ram Mukunda incorporating a settlement and compromise under Bankruptcy Rule 9019 and section 1123(b)(3)(A) of the Bankruptcy Code and providing for, each as of the Effective Date, (a) the immediate release by Reorganized Operating and the other Reorganized Debtors of any Claims against Ram Mukunda relating to or arising under the Mukunda Note; (b) the release by Ram Mukunda of the Mukunda Claim; and (c) the execution by Ram Mukunda and Reorganized Operating of the Senior Executive Employment Agreement for Mr. Mukunda.

1.1.97. New Common Stock: 50,000,000 shares of voting common stock of Reorganized Holdings, par value \$.001 per share, to be authorized by the Reorganized Holdings Certificate of Incorporation.

1.1.98. New Holdings: A Delaware corporation to be named "Startec Global Communications Holding Company," which will be incorporated on or before the Effective Date if the Alternative Plan is confirmed.

1.1.99. New Preferred Stock: Six thousand three hundred (6,300) shares of voting preferred stock of Reorganized Holdings, par value \$.001 per share, with a liquidation preference of \$1,000 per share (or such lesser number as may be issuable to Allied pursuant to Section 9.9(c)(6) of this Plan), to be authorized by the Reorganized Holdings Certificate of Incorporation and issued by Reorganized Holdings on the Effective Date pursuant to this Plan.

1.1.100. New Subsidiary Certificates of Incorporation: The new certificates or articles of incorporation or formation or an amendment to the current certificates or articles for each of the Reorganized Debtors other than Reorganized Holdings.

1.1.101. New Subsidiary Stock: One thousand (1,000) shares of voting common stock of each of the Subsidiary Debtors, par value \$0.01 per share, to be authorized by the New

Subsidiary Certificates of Incorporation and issued by such Debtors, on or as soon as reasonably practicable after the Effective Date, to New Holdings if the Alternative Plan is confirmed.

1.1.102. New Warrant: A common stock purchase warrant granting to NTFC the right to purchase 1,750,000 shares of New Common Stock at an exercise price of \$0.40 per share, as more fully provided in a warrant agreement substantially in the form attached hereto as Exhibit B.

1.1.103. Non-Debtor Subsidiary: Any corporation that is directly or indirectly wholly owned or controlled by a Debtor or Reorganized Debtor and which is not one of the Debtors.

1.1.104. NTFC: NTFC Capital Corporation, a Delaware corporation.

1.1.105. NTFC Claim: The Claim in the amount of \$38,848,464.71 by NTFC arising from its pre-petition secured loan to Holdings, secured by Liens on all or substantially all Assets of Operating and Startec Global Communications UK LTD. and by a pledge by Holdings of the stock of Operating, pursuant to that certain Loan and Security, dated as of December 31, 1998, by and between NTFC and Startec Global Communications Corporation (Maryland), and all amendments thereto.

1.1.106. NTFC Releasees: NTFC and its current and former officers, directors, shareholders, employees, consultants, attorneys and other representatives.

1.1.107. Old Holdings Certificate of Incorporation: The certificate of incorporation of Holdings in effect as of the Filing Date.

1.1.108. Old Holdings Common Stock: The common stock of Holdings, par value \$.01 per share, issued and outstanding as of the Filing Date.

1.1.109. Old Holdings Equity Interest: Any Equity Interest evidenced by Old Holdings Common Stock and any other Equity Interest in Holdings.

1.1.110. Order: An order or judgment of the Bankruptcy Court as entered on the docket.

1.1.111. Operating: Startec Global Operating Company, a Delaware corporation.

1.1.112. Other Priority Claim: Any Claim against the Consolidated Debtors accorded priority in right of payment under section 507(a) of the Bankruptcy Code, other than a Priority Tax Claim or an Administrative Expense.

1.1.113. Plan: This Plan of Reorganization, Including, as applicable, the Alternative Plan or the Consolidated Plan, together with all exhibits and schedules hereto, as it may be amended or modified from time to time in accordance with this Plan, the Bankruptcy Code and the Bankruptcy Rules.

1.1.114. Plan Documents: The documents (other than this Plan) and instruments to be issued, executed, delivered, assumed and/or performed in conjunction with Consummation of this Plan as of, or as soon as reasonably practicable after, the Effective Date, including the Modified Allied Secured Note, the Modified NTFC Secured Note, the Modified NTFC Junior Note, the Post Reorganization Credit Agreement (including all documents necessary to create, continue or perfect a valid security interest thereunder), the Mukunda Note and Claim Agreement, the Senior Executive Employment Agreements, the New Warrant, the New Subsidiary Certificates of Incorporation, the Reorganized Holdings Certificate of Incorporation, the Reorganized Holdings By-Laws, and the Employee Incentive Plan.

1.1.115. Post-Reorganization Credit Agreement: An agreement governing the debt obligations represented by the Modified Allied Secured Note, the Modified NTFC Secured Note, and the Modified NTFC Junior Secured Note, which agreement shall contain the terms and conditions set forth in Exhibit A hereto and shall otherwise be in form and substance acceptable to the Reorganized Debtors, Allied and NTFC.

1.1.116. Pre-Petition Claim: A Claim arising before the Filing Date or a Claim of the kind specified in sections 502(g), 502(h) or 502(i) of the Bankruptcy Code.

1.1.117. Pre-Petition Note Claims: Any and all Claims of the Indenture Trustee and Holders of Pre-Petition Notes arising under the Indenture, the Pre-Petition Notes or the transaction, agreements or Instruments upon which the Pre-Petition Notes are based, including any and all Claims asserted by the Indenture Trustee in the Proof of Claim in the amount of \$171,200,000.00, dated March 29, 2002 or any amendment of replacement thereof.

1.1.118. Pre-Petition Notes: The 12% Senior Notes due 2008 that were issued by Holdings pursuant to the Indenture.

1.1.119. Priority Tax Claim: A Claim of a Governmental Unit against the Consolidated Debtors entitled to priority of payment under section 507(a)(8) of the Bankruptcy Code.

1.1.120. Professional: An Entity (a) employed by the Consolidated Debtors or the Committee pursuant to a Final Order of the Bankruptcy Court in accordance with sections 327 and 1103 of the Bankruptcy Code and to be compensated for services rendered on or after the Filing Date and prior to the Effective Date, pursuant to sections 327, 328, 330 and 331 of the Bankruptcy Code, or (b) for which compensation and reimbursement has been sought before the Bankruptcy Court pursuant to section 503(b)(4) of the Bankruptcy Code.

1.1.121. Professional Fee Claim: Those fees and expenses claimed by Professionals in the Chapter 11 Cases of the Consolidated Debtors, pursuant to sections 327, 328, 330, 331 and/or 503(b) of the Bankruptcy Code, and unpaid as of the Effective Date.

1.1.122. Proof of Claim: A proof of claim Filed in any or all of the Chapter 11 Cases pursuant to section 501 of the Bankruptcy Code and/or any order of the Bankruptcy Court, together with supporting documents.

1.1.123. Pro Rata Share: Proportionately so that, with respect to an Allowed Claim in a particular Class, the ratio of (a) (i) the amount of property distributed on account of the Allowed Claim to (ii) the Allowed amount of such Claim is the same as the ratio of (b) the amount of property distributed on account of all Allowed Claims in the Class in which the particular Claim is included to (ii) the amount of all Claims (Including Disputed Claims, but not Including Disallowed Claims) in that Class.

1.1.124. Remaining Outstanding Percent: That percent of the Allowed Allied Tranche B Claim or the Allied Tranche A Claim, by which such Claim is reduced, through (i) the payment to Allied of Cash by (or through) Holdings, or (ii) the acquisition of Assets of Holdings by Allied, if the Alternative Plan is confirmed, as and under the conditions specified in Section 9.9(c) of this Plan.

1.1.125. Reorganized Debtors:

- (a) If the Consolidated Plan is confirmed, the Debtors from and after the Effective Date; or
- (b) If the Alternative Plan is confirmed, the Subsidiary Debtors and New Holdings from and after the Effective Date.

1.1.126. Reorganized Holdings: From and after the Effective Date,

- (a) If the Consolidated Plan is confirmed, Holdings from and after the Effective Date.
- (b) If the Alternative Plan is confirmed, New Holdings.

1.1.127. Reorganized Holdings By-Laws: The By-Laws of Reorganized Holdings.

1.1.128. Reorganized Holdings Certificate of Incorporation: The certificate of incorporation of Reorganized Holdings, substantially in the form attached hereto as Exhibit C.

1.1.129. Reorganized Operating: Operating from and after the Effective Date.

1.1.130. Satisfied Percent: One hundred percent (100%) minus the Remaining Outstanding Percent.

1.1.131. Schedule of Assumed Contracts: The schedule of executory contracts and unexpired leases to be assumed by the Consolidated Debtors submitted in accordance with Section 8.1 of this Plan.

1.1.132. Scheduled: With respect to a Claim, the Claim is listed on the Schedules.

1.1.133. Schedules: The schedules of assets and liabilities that the Debtors have Filed pursuant to section 521 of the Bankruptcy Code and the Bankruptcy Rules, as they may be amended and supplemented from time to time.

1.1.134. Secured Claim: (a) a Claim that is secured by a Lien on property in which the Estates have an interest, which Lien is valid, perfected and enforceable under applicable law or by reason of a Final Order, or that is (subject to Section 10.10(c) of this Plan) subject to setoff under section 553 of the Bankruptcy Code, to the extent of the value of the Creditor's interest in the Estates' interest in such property or to the extent of the amount subject to setoff, as applicable, as determined pursuant to section 506(a) of the Bankruptcy Code, or (b) a Claim Allowed under this Plan as a Secured Claim.

1.1.135. Senior Executive Employment Agreements: The employment agreements, effective on the Effective Date, between Reorganized Operating and Ram Mukunda and Prabhav V. Maniyar, which agreements shall supersede any prior employment agreements. The material terms of the Senior Executive Employment Agreements for Ram Mukunda and Prabhav V. Maniyar are attached hereto as Exhibit D.

1.1.136. Subordinated Claim: Any Claim, whether arising from the sale or issuance of an Equity Interest or otherwise, that is subordinated to the same level as Old Holdings Equity Interests pursuant to section 510(b) of the Bankruptcy Code.

1.1.137. Subsidiary Debtors: Operating and Licensing.

1.1.138. Subsidiary Equity Interests: Any and all Equity Interests in a Subsidiary Debtor outstanding as of the Filing Date.

1.1.139. Uniform Commercial Code: The Uniform Commercial Code as in effect in the State of Maryland as of the date hereof.

1.1.140. Unsecured Stock Distribution: Shares of New Common Stock, to be distributed to Holders of Allowed General Unsecured Claims in Class 3A of this Plan, subject to, as provided in, and in accordance with Sections 6.3.1 and 11.6 of this Plan.

1.1.141. Valuation Amount: As to the GE Capital Secured Claim (Class 2E) and the Heller Secured Claim (Class 2F), the lesser of the Allowed Amount of such Claim or the value of, as applicable, the GE Capital Equipment or the Heller Equipment, as determined by the Bankruptcy Court in accordance with section 506(c) of the Bankruptcy Code, or by agreement of the Reorganized Debtors and the Holder of the Claim.

1.2. Interpretations. Whenever from the context it appears appropriate, each term stated in either the singular or the plural shall include the singular and the plural, and pronouns stated in the masculine, feminine or neuter gender shall include the masculine, the feminine, and the neuter. Unless otherwise defined in this Plan, all accounting terms shall be construed in accordance with generally accepted accounting principles in the United States of America. Unless otherwise specified, all section or exhibit references in this Plan are to the respective section in, or exhibit to, this Plan. The words "herein," "hereof," "hereto," "hereunder," and other words of similar import refer to this Plan as a whole and not to any particular section,

subsection or clause contained therein. Any capitalized term used herein that is not defined herein shall have the meaning assigned to that term in the Bankruptcy Code. The rules of construction contained in section 102 of the Bankruptcy Code shall apply to this Plan. The headings in this Plan are for convenience of reference only and shall not limit or otherwise affect the provisions hereof. To the extent that there is any inconsistency between any provisions of this Plan and any of the provisions contained in the Plan Documents to be entered into as of the Effective Date, the Plan Documents shall control. To the extent that there is any inconsistency between the provisions contained in this Plan and any description thereof in the Disclosure Statement, this Plan shall control.

## ARTICLE TWO

### TREATMENT OF ADMINISTRATIVE CLAIMS

2.1. Administrative Expenses. On the latter of (a) the Effective Date (or as soon thereafter as is reasonably practicable), (b) five Business Days after the Allowance Date with respect to such Allowed Administrative Expense, or (c) such later date on which the Consolidated Debtors and the Holder of the Administrative Expense otherwise agree, each Allowed Administrative Expense, other than a Professional Fee Claim, Allied Tranche A Claim or the Allied Tranche B Claim, shall receive, on account of and in full and complete satisfaction, settlement, release and discharge of such Allowed Administrative Expense, (a) Cash equal to the unpaid portion of such Allowed Administrative Expense, or (b) such other less favorable treatment as to which the Consolidated Debtors and the Holder of the Administrative Expense shall have agreed upon in writing; provided, however, Allowed Administrative Expenses with respect to liabilities incurred by the Consolidated Debtors in the ordinary course of business during the Chapter 11 Cases shall, at the option of the Consolidated Debtors, be paid in the ordinary course of business in accordance with the terms and conditions of any agreements relating thereto.

2.2. Professional Fees.

Each Professional seeking any award in respect of a Professional Fee Claim incurred through and including the Confirmation Date shall be required to file and serve a final application for allowance of compensation and reimbursement of expenses on or before the date that is sixty days after the Effective Date. Within five Business Days after a Professional Fee Claim is Allowed by Final Order, the Professional shall receive, on account of and in full and complete satisfaction, settlement, release and discharge of its Allowed Professional Fee Claim, (a) Cash equal to the amount awarded to such Professional by Final Order of the Bankruptcy Court, less all amounts previously paid to such Professional pursuant to any order of the Bankruptcy Court providing for payment of interim compensation to Professionals, or (b) such other less favorable treatment as to which the Consolidated Debtors and such Professional shall have agreed upon in writing.

Any reasonable fees and expenses of Professionals or other attorneys, accountants or other professionals retained by the Consolidated Debtors or the Reorganized Debtors for services rendered after the Confirmation Date, including those for services rendered after the Effective Date relating to objections to Disputed Claims and the implementation of this Plan, shall not require the filing of any applications with the Bankruptcy Court and may be paid by the

Reorganized Debtors in the ordinary course of business and without further Bankruptcy Court approval.

2.3. Allied Tranche B Claim. On the Effective Date (or as soon thereafter as is reasonably practicable), Allied shall receive, on account of and (subject to Section 9.9(c) of this Plan) in full and complete satisfaction, settlement, release and discharge of the Allowed Allied Tranche B Claim, (a) the Modified Allied Secured Note and (b) payment of any accrued and unpaid interest and other amounts due.

### ARTICLE THREE TREATMENT OF PRIORITY TAX CLAIMS

3.1. Priority Tax Claims. Each Holder of an Allowed Priority Tax Claim shall receive, on account of and in full and complete satisfaction, settlement, release and discharge of such Allowed Priority Tax Claim, at the sole option of the Reorganized Debtors:

- (a) On the latter of (i) the Effective Date (or as soon thereafter as is reasonably practicable), (ii) five Business Days after the Allowance Date with respect to such Allowed Priority Tax Claim, or (iii) the date on which the Reorganized Debtors and the Holder of such Allowed Priority Tax Claim otherwise agree, Cash in an amount equal to such Allowed Priority Tax Claim;
- (b) Beginning on the first anniversary following the Effective Date or such earlier date as the Bankruptcy Court may order, Cash payments made in equal annual installments, with the final installment being payable no later than the sixth anniversary of the date of the assessment of such Allowed Priority Tax Claim, in an aggregate amount equal to such Allowed Priority Tax Claim, together with interest on the unpaid balance of such Allowed Priority Tax Claim calculated from the Effective Date through the date of payment at the Applicable Rate; or
- (c) Such other treatment agreed to by the Holder of such Allowed Priority Tax Claim and the Reorganized Debtors.

### ARTICLE FOUR CLASSIFICATION OF CLAIMS AND INTERESTS

4.1. Classification of Classes Pursuant to Sections 1122 and 1123(a)(1) of the Bankruptcy Code. Allowed Claims and Equity Interests are classified under this Plan as follows (other than Administrative Expenses and Priority Tax Claims, which are not classified as provided in section 1123(a)(1) of the Bankruptcy Code and are, instead, addressed in Articles Two and Three of this Plan). A Claim or Interest is placed in a particular Class for the purposes of voting on this Plan and of receiving distributions pursuant to this Plan only to the extent that such Claim or Interest is an Allowed Claim or Interest in that Class and such Claim or Interest has not been paid, released or otherwise settled prior to the Effective Date.

4.2. Claims.

Class 1. Class 1 consists of all Other Priority Claims.



Class 2A. Class 2A consists of the NTFC Claim.

Class 2B. Class 2B consists of the Allied Tranche A Claim.

Class 2C. Class 2C consists of the Allied Other Secured Claim.

Class 2D. Class 2D consists of the Avaya Secured Claim

Class 2E. Class 2E consists of the GE Capital Secured Claim.

Class 2F. Class 2F consists of the Heller Secured Claim.

Class 2G. Class 2G consists of the CIT Secured Claim.

Class 2H. Class 2H consists of all Miscellaneous Secured Claims.

Class 3A. Class 3A consists of all General Unsecured Claims other than those in the Convenience Class.

Class 3B. Class 3B consists of the Allied Unsecured Claim.

Class 3C. Class 3C consists of all General Unsecured Claims in the Convenience Class.

Class 4. Class 4 consists of the Pre-Petition Note Claims.

Class 5. Class 5 consists of all Intercompany Claims.

4.3. Equity Interests.

Class 6. Class 6 consists of all Old Holdings Equity Interests and any Subordinated Claims.

Class 7. Class 7 consists of all Subsidiary Equity Interests.

ARTICLE FIVE  
IDENTIFICATION OF CLASSES OF CLAIMS AND INTERESTS  
IMPAIRED AND NOT IMPAIRED BY THIS PLAN

5.1. Classes of Claims and Equity Interests Impaired by this Plan and Entitled to Vote. The NTFC Claim (Class 2A), Allied Tranche A Claim (Class 2B), the Allied Other Secured Claim (Class 2C), the Avaya Secured Claim (Class 2D), the GE Capital Secured Claim (Class 2E), the Heller Secured Claim (Class 2F); the CIT Secured Claim (Class 2G), General Unsecured Claims (Class 3A), the Allied Unsecured Claim (Class 3B), the Convenience Class (Class 3C), and Pre-Petition Note Claims (Class 4) are Impaired by this Plan and the Holders of Allowed Claims in such Classes are entitled to vote to accept or reject this Plan; provided, however, if the Alternative Plan is confirmed, Holders of Allowed Claims in Class 2D and Class 4, and any other Holders of Allowed Claims against Holdings, shall be deemed not to be Impaired and shall not be entitled to vote such Claims with respect to the Alternative Plan.

5.2. Classes of Claims and Equity Interests Not Impaired by this Plan and Conclusively Presumed to Accept this Plan. Other Priority Claims (Class 1), Miscellaneous Secured Claims (Class 2H), and (provided that the Consolidated Plan, and not the Alternative Plan, is confirmed) the Subsidiary Equity Interests (Class 7) are not Impaired by this Plan. Under section 1126(f) of the Bankruptcy Code, the Holders of such Claims and Equity Interests are conclusively presumed to accept this Plan, and the acceptances of such Holders will not be solicited.

5.3. Classes of Claims and Equity Interests Impaired by this Plan and Deemed Not to Have Accepted this Plan. Intercompany Claims (Class 5) and (subject to Section 9.9(c) of this Plan) Old Holdings Equity Interests (Class 6) are Impaired by this Plan and do not receive or retain any property under this Plan provided, however, if the Alternative Plan is confirmed, Holders of Old Holdings Equity Interests (Class 6) shall be deemed not to be Impaired and shall not be entitled to vote such Equity Interest with respect to the Alternative Plan as confirmed. In addition, if the Alternative Plan is confirmed, the Subsidiary Equity Interests will be Impaired and will not receive any property under this Plan. Under section 1126(g) of the Bankruptcy Code, the Holders of the Intercompany Claims, the Old Holdings Equity Interests and, if the Alternative Plan is confirmed, the Subsidiary Equity Interests are deemed not to have accepted this Plan. However, the Holders of the Intercompany Claims and the Subsidiary Equity Interests are co-proponents of and support this Plan.

## ARTICLE SIX

### TREATMENT OF CLAIMS AND INTERESTS

#### 6.1. Other Priority Claims (Class 1).

On the latest of (a) the Effective Date (or as soon thereafter as is reasonably practicable), (b) five Business Days after the Allowance Date for such Other Priority Claim, or (c) the date on which the Consolidated Debtors and the Holder of such Allowed Other Priority Claim otherwise agree, each Holder of an Allowed Other Priority Claim shall receive, on account of and in full and complete settlement, release and discharge of such Allowed Other Priority Claim, (a) Cash equal to the amount of such Allowed Other Priority Claim or (b) such other treatment as to which the Reorganized Debtors and such Holder shall have agreed upon in writing in an amount sufficient to render such Allowed Priority Claim not Impaired under section 1124 of the Bankruptcy Code.

Class 1 is not Impaired and is conclusively presumed to have accepted this Plan.

#### 6.2. Secured Claims.

##### 6.2.1. NTFC Claim (Class 2A).

Subject to Section 9.9(c), the NTFC Claim shall be Allowed in the amount of \$38,848,464.71 as of the Filing Date. On the Effective Date (or as soon thereafter as is reasonably practicable), NTFC shall receive on account of and in full and complete settlement, release, and discharge of the NTFC Claim, (A) the Modified NTFC Secured Note, (B) the Modified NTFC Junior Note, (C) the New Warrant, (D) 700,000 shares of New Common Stock, and (E) either (i) an additional 525,000 shares of New Common Stock if Class 3A does not vote

to accept this plan; or (ii) an additional 175,000 shares of New Common Stock if Class 3A votes to accept this Plan but either or both of Class 3C and Class 4 vote to reject this Plan or the Alternative Plan is confirmed.

Class 2A is Impaired and is entitled to vote on this Plan.

6.2.2. Allied Tranche A Claim (Class 2B).

The Allied Tranche A Claim shall be Allowed in the amount of \$16,315,000 as of the Filing Date and shall, with Allied's consent, be treated solely for purposes of this Plan as a Secured Claim arising before the Filing Date, not as an Administrative Expense arising on or after the Filing Date. On the Effective Date (or as soon thereafter as is reasonably practicable), Allied shall, subject to Allied's election under Sections 6.2.3 and 6.3.2, receive on account of and (subject to Section 9.9(c) of this Plan) in full and complete settlement, release and discharge of the Allied Tranche A Claim, (A) 6,300 shares of New Preferred Stock; (B) 25,200,000 shares of New Common Stock; and (C) either (i) an additional 1,575,000 shares of New Common Stock if Class 3A does not vote to accept this plan; or (ii) an additional 525,000 shares of New Common Stock if Class 3A votes to accept this Plan but either or both of Class 3C and Class 4 vote to reject this Plan or the Alternative Plan is confirmed.

Class 2B is Impaired and is entitled to vote on this Plan.

6.2.3. Allied Other Secured Claim (Class 2C).

On the Effective Date (or as soon thereafter as is reasonably practicable), Allied shall, subject to its election right in this subsection, receive, on account of the Allied Other Secured Claim, \$1.00 in Cash. All Liens securing the Allied Other Secured Claim shall be deemed released and of no further force and effect, and, except as provided for in the following sentence, no other distributions shall be made in respect of the Allied Other Secured Claim. Allied's agreement to accept the treatment of the Allied Other Secured Claim as set forth above is conditioned upon and in consideration for Allied's right to elect that a portion of the New Common Stock being distributed to Allied under this Plan, be distributed on account of Allied's Claim in this Class 2C. Allied shall, on or before the Effective Date, notify the Reorganized Debtors of the number of shares of the New Common Stock that shall be exchanged for the Claim represented in this Class 2C.

Class 2C is Impaired and is entitled to vote on the Plan.

6.2.4. Avaya Secured Claim (Class 2D).

If the Consolidated Plan is confirmed the Avaya Secured Claim shall be allowed in the amount of \$15,000. Avaya shall receive, in full and complete settlement, release and discharge of the Avaya Claim, six Cash payments made in equal monthly installments of \$2,500 beginning on the first day of the first full month following the Effective Date, without interest. Avaya shall retain a Lien on the Avaya Equipment to secured the Avaya Secured Claim. On and after the Effective Date, the Avaya Equipment and any other equipment sold or leased by Avaya to Reorganized Holdings shall be deemed owned by Reorganized Holdings, subject to the Lien

securing payment of the Avaya Secured Claim, notwithstanding any lease agreements or other documents executed before the Filing Date under which the Holder of the Avaya Secured Claim purported to retain title to the Avaya Equipment (all such documents shall be of no further force and effect). Upon payment in full of the Avaya Secured Claim, Reorganized Holdings shall own the Avaya Equipment free and clear of such secured Claim and Lien. The Holder of the Avaya Claim shall receive no distribution under this Plan in respect of any amount of the Avaya Claim greater than the Avaya Secured Claim, and any such deficiency portion of the Avaya Claim shall be discharged in full. Class 2D is Impaired under the Consolidated Plan and is entitled to vote on the Consolidated Plan.

If the Alternative Plan is confirmed, the claims and rights of the Holder of the Avaya Secured Claim vis-à-vis Holdings shall be fully preserved. Class 2D is not Impaired under the Alternative Plan and is therefore not entitled to vote on the Alternative Plan.

6.2.5. GE Capital Secured Claim (Class 2E) and Heller Secured Claim (Class 2F).

On the Effective Date, the GE Capital Claim shall be Allowed in the amount of \$641,736.46, and the Heller Claim shall be Allowed in the amount of \$1,508,099.11. The GE Secured Claim shall equal the Valuation Amount of the GE Capital Equipment. The Heller Secured Claim shall equal the Valuation Amount of the Heller Equipment.

Valuation Amount: At the sole option of the Reorganized Debtors, on the Effective Date, or as soon thereafter as is reasonably practicable, the Holder of the GE Capital Secured Claim (Class 2E) and the Heller Secured Claim (Class 2F) shall, in full and complete settlement of the GE Secured Claim and the Heller Secured Claim, respectively, be (a) paid in full in Cash (or the indubitable equivalent) in an amount equal to the Valuation Amount of such Secured Claim, (b) satisfied by returning to the Holder of such Claim the GE Capital Equipment or the Heller Equipment, respectively, (c) given a five-year promissory note for payment of the Valuation Amount, plus interest thereon from the Effective Date through the date of payment in full at the Applicable Rate, secured by the GE Capital Equipment and the Heller Equipment, respectively or (d) paid and/or satisfied through any combination of subparagraphs (a), (b) and (c) of this Section 6.2.5 of the Plan. On and after the Effective Date, the GE Capital Equipment and the Heller Equipment and any other equipment sold or leased by the Holder of the GE Capital Secured Claim and the Heller Secured Claim to Debtors shall be deemed owned by the Reorganized Debtors, subject to the Lien securing payment of the GE Capital Secured Claim and the Heller Secured Claim, notwithstanding any lease agreements or other documents executed before the Filing Date under which the Holder of the GE Capital Secured Claim and the Heller Secured Claim purported to retain title to the GE Capital Equipment or the Heller Equipment (all such documents shall be of no further force and effect). Upon payment in full of the GE Capital Secured Claim and the Heller Secured Claim, Reorganized Holdings shall own the GE Capital Equipment and the Heller Equipment, respectively, free and clear of such Secured Claims and Liens.

Unsecured Amount: On account of any deficiency between (i) the Allowed amount of the GE Capital Claim and the Allowed amount of the Heller Claim, and (ii) the Valuation Amount of such Claims, the Holder of the GE Capital Claim (Class 2E) and the Heller Claim

(Class 2F) shall receive no distributions under this Plan and any such deficiency portion of the GE Capital Claim and the Heller Claim shall be discharged in full.

Class 2E and Class 2F are Impaired and entitled to vote on this Plan.

6.2.6. CIT Secured Claim (Class 2G).

On the Effective Date, the CIT Secured Claim shall be Allowed in the amount of \$643,941. On account of and in full and complete settlement, release and discharge of the CIT Secured Claim, the Holder of the CIT Secured Claim shall retain its Lien on the CIT Equipment (until the CIT Secured Claim is paid in full), which shall secure repayment of the CIT Secured Claim, and shall receive, (i) on the first day of the first month following the Effective Date, a Cash payment of \$25,000, (ii) commencing on the first day of the first full month following the Effective Date, monthly Cash payments in the amount of \$10,200 each for 40 months, and (iii) a Cash payment of \$26,000 due 42 months from the Effective Date. Certain CIT Equipment, specifically certain interface cards, a display monitor, and certain phone sets shall be returned to the Holder of the CIT Claim. On and after the Effective Date, all remaining CIT Equipment shall be deemed owned by Reorganized Operating, subject to the Lien securing payment of the CIT Secured Claim, notwithstanding any lease agreements or other documents executed before the Filing Date under which the Holder of the CIT Secured Claim purported to retain title to the CIT Equipment (all of such documents shall be of no further force and effect). Upon payment in full of the CIT Secured Claim, Reorganized Operating shall own the CIT Equipment free and clear of such Lien. The Holder of the CIT Claim shall receive no distribution under this Plan in respect of any amount of the CIT Claim greater than the CIT Secured Claim, and any such deficiency portion of the CIT Claim shall be discharged in full.

Class 2G is Impaired and is entitled to vote on this Plan.

6.2.7. Miscellaneous Secured Claims (Class 2H).

On the latest of (i) the Effective Date, (ii) the date on which such Miscellaneous Secured Claim becomes an Allowed Claim, and (iii) the date on which the Consolidated Debtors and the Holder of such Allowed Miscellaneous Secured Claim otherwise agree, at the election of the Consolidated Debtors prior to the Effective Date, each Holder of an Allowed Miscellaneous Secured Claim shall be entitled to receive, on account of such Holder's Miscellaneous Secured Claim, one of the following treatments: (A) the unaltered legal, equitable and contractual rights to which such Holder of an Allowed Miscellaneous Secured Claim is entitled, (B) such Holder's Allowed Miscellaneous Secured Claim shall be reinstated and rendered Unimpaired in accordance with section 1124(2) of the Bankruptcy Code, C) such other treatment as mutually agreed to by the such Holder and the Consolidated Debtors so as not to render such Claim Impaired.

Class 2H is not Impaired and is conclusively presumed to have accepted this Plan.

6.3. Unsecured Claims.

6.3.1. General Unsecured Claims (Class 3A).

If Class 3A votes to accept this Plan, each Holder of an Allowed General Unsecured Claim in such Class shall, on account of and in full and complete settlement, release and discharge of such Claim, receive from Reorganized Holdings as soon as reasonably practicable following the later of the Claims Objection Deadline for all General Unsecured Claims or the Allowance Date for such Allowed General Unsecured Claim, its Pro Rata Share of 1,400,000 shares of New Common Stock in accordance with Sections 11.3 and 11.6 of this Plan.

If Class 3A votes not to accept this Plan, no New Common Stock will be issued to Class 3A, each Holder of a Class 3A Allowed General Unsecured Claim shall not receive or retain any property or interest in property on account of such Class 3A Claim, and all Class 3A Claims shall be discharged in accordance with this Plan and section 1141 of the Bankruptcy Code.

Class 3A is Impaired and is entitled to vote on this Plan.

6.3.2. Allied Unsecured Claim (Class 3B).

On the Effective Date or as soon thereafter as is reasonably practicable, Allied will receive, on account of the Allied Unsecured Claim, \$1.00 in Cash. Except as provided in the following sentence, no other distributions will be made in respect of the Allied Unsecured Claims. Allied's agreement to accept the treatment of its Claim as set forth above is conditioned upon and in consideration for Allied's right to elect that a portion of the New Common Stock being distributed under this Plan to Allied on account of Allied's Claim in this Class 3B. Allied shall, on or before the Effective Date, notify the Reorganized Debtors of the number of shares of the New Common Stock that shall be exchanged for the Claim represented in this Class 3B.

Class 3B is Impaired and is entitled to vote on this Plan.

6.3.3. Convenience Class (Class 3C).

If Class 3C Votes to accept this Plan, on the Allowance Date for such Allowed Convenience Class Claims (or as soon thereafter as is reasonably practicable), each Holder of an Allowed Convenience Class Claim shall receive on account of and in full and complete settlement, release and discharge of such Convenience Class Claim, Cash equal to five percent (5%) of the Allowed amount of such Allowed Convenience Class Claim.

If Class 3C votes not to accept this Plan, no Holder of a Class 3C Allowed General Unsecured Claim shall receive or retain any property or interest in property on account of such Class 3C Claim, and all Class 3C Claims shall be discharged in accordance with this Plan and section 1141 of the Bankruptcy Code.

Class 3C is Impaired and is entitled to vote on this Plan

6.3.4. Pre-Petition Note Claims (Class 4).

If (a) Classes 3A, 3B and 4 vote to accept this Plan and (b) the Consolidated Plan is confirmed, then, on the Effective Date (or as soon thereafter as is reasonably practicable), each Holder of an Allowed Pre-Petition Note Claim shall receive, on account of and in full and

complete settlement, release, and discharge of such Allowed Pre-Petition Note Claim, its Pro Rata Share of 700,000 shares of New Common Stock.

If any of Classes 3A, 3C or 4 vote not to accept this Plan and the Consolidated Plan is confirmed, no Holder of a Pre-Petition Note Claim shall receive any shares of New Common Stock or receive or retain any property or interest in property on account of such Class 4 Claim, and all Class 4 Claims shall be discharged in accordance with this Plan and section 1141 of the Bankruptcy Code.

If the Alternative Plan is confirmed, the Claims of the Holders of the Pre-Petition Notes Claims vis-à-vis Holdings shall be fully preserved and shall not be affected by the Alternative Plan. The Holders of the Pre-Petition Note have Filed no Proof of Claim, and have no Claim, against the Subsidiary Debtors.

Class 4 is Impaired under the Consolidated Plan and is entitled to vote on the Consolidated Plan.

Class 4 is not Impaired under the Alternative Plan and is not entitled to vote on the Alternative Plan.

6.4. Intercompany Claims (Class 5).

On the Effective Date, all Intercompany Claims will be extinguished and no distributions will be made in respect of such Intercompany Claims.

Class 5 is Impaired and is deemed to have rejected this Plan.

6.5. Old Holdings Equity Interests (Class 6).

On the Effective Date, if the Consolidated Plan is confirmed, all Old Holdings Equity Interests will be extinguished and no distributions will be made in respect of such Old Holdings Equity Interests and all outstanding shares of Old Holdings Common Stock and any options, warrants or other rights to acquire Old Holdings Common Stock shall be cancelled. Class 6 is Impaired under the Consolidated Plan and is deemed to reject the Consolidated Plan.

If the Alternative Plan is confirmed, the Equity Interests of the Holders of Old Holdings Equity Interests shall be fully preserved and shall not be affected by the Alternative Plan. Class 6 is not Impaired under the Alternative Plan and is not entitled to vote on the Alternative Plan.

6.6. Subsidiary Equity Interests (Class 7).

If the Consolidated Plan is confirmed, Holdings shall retain the Subsidiary Equity Interests and its respective share or shares of common stock of such Debtors representing such Subsidiary Equity Interests. Class 7 is not Impaired under the Consolidated Plan and is conclusively presumed to have accepted the Consolidated Plan.

If the Alternative Plan is confirmed, on the Effective Date, all Subsidiary Equity Interests will be extinguished and no distribution will be made in respect of such Subsidiary Equity

Interests. Class 7 is Impaired under the Alternative Plan and is deemed to have rejected the Alternative Plan.

ARTICLE SEVEN  
ACCEPTANCE OR REJECTION OF THIS PLAN; EFFECT OF  
REJECTION BY ONE OR MORE IMPAIRED  
CLASSES OF CLAIMS OR INTERESTS

7.1. Acceptance by an Impaired Class of Creditors. Consistent with section 1126(c) of the Bankruptcy Code, an Impaired Class of Claims shall have accepted this Plan if this Plan is accepted by Holders of at least two-thirds in dollar amount and more than one-half in number of the Allowed Claims in such Class that have timely and properly voted to accept or reject this Plan by so marking and returning their Ballots.

7.2. Confirmation Pursuant to Section 1129(b) of the Bankruptcy Code. With respect to any Impaired Class that does not accept this Plan, the Debtors intend to request that the Bankruptcy Court confirm this Plan in accordance with section 1129(b) of the Bankruptcy Code.

ARTICLE EIGHT  
UNEXPIRED LEASES AND EXECUTORY CONTRACTS

8.1. Assumption and Rejection of Executory Contracts and Unexpired Leases.

- (a) On the Effective Date subject to Section 9.9 hereof, all executory contracts and unexpired leases to which any or all of the Consolidated Debtors are a party shall be deemed rejected, except for any executory contracts or unexpired leases that (a) have already, by such date, been assumed or rejected pursuant to Final Order of the Bankruptcy Court, (b) are designated as a contract or lease to be assumed on the Schedule of Assumed Contracts attached as Exhibit E hereto, as such Schedule of Assumed Contracts may be amended from time to time on or prior to the Confirmation Date, or (c) are the subject of a separate motion by the Debtors to assume or reject pursuant to section 365 of the Bankruptcy Code. The Debtors may amend the Schedule of Assumed Contracts at any time on or prior to the Confirmation Date by filing such amendment with the Bankruptcy Court and serving it on the non-Debtor parties to the executory contracts or unexpired leases added to or deleted from the Schedule of Assumed Contracts.
- (b) On the Effective Date, each executory contract or unexpired lease of any and all of the Consolidated Debtors on the Schedule of Assumed Contracts, as it may be amended from time to time on or prior to the Confirmation Date, shall be assumed by the Consolidated Debtor identified in the Schedule of Assumed Contracts as the Debtor-party to such executory contract or unexpired lease. Each executory contract and unexpired lease assumed pursuant to this Plan by any Consolidated Debtor shall revert in, be deemed assigned to, and be fully enforceable by, the applicable Reorganized Debtor on and after the Effective Date.
- (c) Notwithstanding anything to the contrary contained herein, the Consolidated Debtors reserve the right, through the date that is 90 days after the Effective Date,



to file a motion, complaint or other pleading with the Bankruptcy Court seeking to "recharacterize" as, or declare that any agreement in the form of a lease of personal or real property is, a financing. To the extent that, in response to such a pleading, the Bankruptcy Court enters a Final Order, either before, on, or after the Effective Date, that any such agreement identified for assumption pursuant to this Plan is, in fact, a financing transaction, the non-Debtor party to the Agreement shall have a Miscellaneous Secured Claim to the extent that its Claim for the indebtedness resulting from the recharacterization as a Secured Claim secured by an unavoidable Lien and, to any other extent, a General Unsecured Claim.

8.2. Bar Date for Rejection Damages. Unless otherwise provided by a Final Order of the Bankruptcy Court entered prior to the Confirmation Date, if the rejection of any executory contract or unexpired lease of any and all of the Consolidated Debtors gives rise to any Claim against any of the Consolidated Debtors, a Proof of Claim with respect to such Claim must be Filed (with a copy served on the Consolidated Debtors) by (a) the deadline for the filing of such Proof of Claim as specified by the Bankruptcy Court in any order granting any motion by the Consolidated Debtors authorizing the rejection of such executory contract or unexpired lease or (b) if such executory contract or unexpired lease is rejected pursuant to this Plan, rather than pursuant to a separate motion, or otherwise no different deadline is established in any order of the Bankruptcy Court, thirty days from the Confirmation Date. Any Entity that fails to File and serve a Proof of Claim with respect to any Claim it has arising from or relating to such a rejection within the period set forth above shall be forever barred from asserting any such Claim against any or all of the Consolidated Debtors, Reorganized Debtors or the property or interests in property of the Consolidated Debtors or Reorganized Debtors. All Claims arising from the rejection of executory contracts or unexpired leases shall be classified as a General Unsecured Claim; provided, however, with respect to any unexpired lease of equipment that is rejected (and that is not "recharacterized" under Section 8.1(c) hereof or that is not addressed in Sections 6.2.4, 6.2.5 or 6.2.6 of this Plan) the equipment shall be returned to the non-Debtor party to the lease.

8.3. Cure of Defaults. Except to the extent that different treatment has been agreed to by the non-Debtor party to any executory contract or unexpired lease to be assumed pursuant to this Plan, the Consolidated Debtors shall, pursuant to sections 365, 1123(a)(5)(G) and 1123(b)(2) of the Bankruptcy Code, within thirty days after the Effective Date, file with the Bankruptcy Court, and serve on the non-Debtor party to each such executory contract or unexpired lease to be assumed, a notice listing the amount needed to cure all defaults by the Consolidated Debtors under the executory contract or unexpired lease to be assumed arising or accruing on or prior to the Effective Date. The non-Debtor party shall have fifteen days from the date of service to file with the Bankruptcy Court and serve on the Consolidated Debtors any objection to the proposed cure or cure amount set forth in the notice served by the Consolidated Debtors. If such an objection is not timely filed and served, the cure or cure amount set forth in the Consolidated Debtors' notice shall control, the Consolidated Debtors shall pay such amount in Cash (unless the Consolidated Debtors and the non-Debtor party to the executory contract or unexpired lease have agreed to different treatment), and the non-Debtor party shall be forever barred from claiming that any additional amount is owed by any of the Consolidated Debtors under the executory contract or unexpired lease as a result of any default arising or accruing on or prior to the Effective Date. If an objection is timely filed and served by the non-Debtor party to the

executory contract or unexpired lease, the Bankruptcy Court shall determine the proper cure or cure amount. Notwithstanding anything to the contrary contained in this Plan, at all times through the date that is five Business Days after the Bankruptcy Court enters an order resolving and fixing any disputed cure or cure amount, the Consolidated Debtors shall have the right to reject such executory contract or unexpired lease, by providing notice to the non-debtor party to the executory contract or unexpired lease.

## ARTICLE NINE

### MEANS OF IMPLEMENTATION OF THIS PLAN

9.1. Vesting of Property. Except as otherwise provided in this Plan, on the Effective Date, title to all property of the Consolidated Debtors' Estates shall pass to and vest in the applicable Reorganized Debtors, free and clear of all Claims, Equity Interests, Liens, security interests, charges and other encumbrances. Confirmation of this Plan (subject to the occurrence of the Effective Date) shall be binding and all Holders of a Claim or Equity Interest in the Consolidated Debtors, and the Consolidated Debtors' debts shall, without in any way limiting Section 12.1 of this Plan, be discharged, as provided in section 1141 of the Bankruptcy Code.

9.2. Funding. In addition to any funding it may provide for expenses incurred by the Reorganized Debtors on or after the Effective Date, Allied may advance up to \$2,000,000 to the Reorganized Debtors on or after the Effective Date to fund Cash payments to be made under this Plan of the Reorganized Debtors. Any such advance shall be added to the principal amount of the Modified Allied Secured Note and shall be repaid on the terms set forth in such note.

9.3. Corporate Action for Reorganized Debtors. On the Effective Date (or as soon as reasonably practicable thereafter), Reorganized Holdings shall file with the Secretary of State of the State of Delaware, in accordance with sections 103 and 303 of the Delaware General Corporation Law, the Reorganized Holdings Certificate of Incorporation and such certificate shall be the certificate of incorporation for Reorganized Holdings. On the Effective Date, the Reorganized Holdings By-Laws shall become the By-Laws of Reorganized Holdings. On the Effective Date (or as soon as reasonably practicable thereafter), each of the Reorganized Debtors (other than Reorganized Holdings) shall file with the Secretary of State of the State of Delaware New Subsidiary Certificates of Incorporation and such New Subsidiary Certificates of Incorporation shall be the certificates of incorporation for the Reorganized Debtors (other than Reorganized Holdings). On the Effective Date, the By-Laws of each Subsidiary Debtor shall become the By-Laws of the respective Reorganized Debtors (other than Reorganized Holdings).

9.4. Implementation. Pursuant to the Confirmation Order and upon Confirmation of this Plan, the Reorganized Debtors shall be authorized to take all necessary or appropriate steps, and perform all necessary or appropriate acts, to consummate the terms and conditions of this Plan. The Reorganized Debtors are hereby authorized to and shall, execute all Plan Documents and Instruments and such other documents, and take such other actions, as are necessary or appropriate to effectuate the transactions provided for in this Plan, without the need for any additional approvals, authorizations or consents.

9.5. Issuance of New Securities, Transfer Taxes. The issuance and distribution of the New Preferred Stock, New Common Stock, New Warrant, Employee Incentive Options and,

under the conditions specified in Section 9.12, the New Subsidiary Stock, is hereby authorized and directed without the need for any further corporate action, under applicable law, regulation, order, rule or otherwise. In accordance with section 1146(c) of the Bankruptcy Code, the issuance, transfer or exchange of a security, or the making or delivery of an instrument of transfer under this Plan, Including the granting or recording of any Lien or mortgage on any property under the Modified Allied Secured Note or the Modified NTFC Secured Note, may not be taxed under any law imposing a stamp tax or similar tax, Including a mortgage recording tax.

9.6. Cancellation of Existing Securities and Agreements. On the Effective Date, except as otherwise provided herein, (i) any instrument or document evidencing or creating any indebtedness or obligation of the Consolidated Debtors shall be cancelled, Including, if the Consolidated Plan is confirmed, the Pre-Petition Notes, as well as any security, note, bond, or indenture, of the Consolidated Debtors, Including all certificates or other documents representing Old Holdings Equity Interests if the Consolidated Plan is confirmed and all certificated and other documents representing Subsidiary Equity Interests if the Alternative Plan is confirmed, and (ii) all Intercompany Claims shall be released and discharged (subject to Section 9.9(d)). Notwithstanding the foregoing, the applicable provisions, and any Liens created thereunder, of the Indenture shall continue solely for the purpose of permitting the Indenture Trustee to make the distributions to be made to the Holders of the Pre-Petition Notes, as provided in and subject to Section 6.3.4 of this Plan.

9.7. Board of Directors and Officers of Reorganized Holdings. On the Effective Date, the operation of Reorganized Holdings shall become the general responsibility of the Board of Reorganized Holdings, subject to, and in accordance with, the Reorganized Holdings Certificate of Incorporation and the Reorganized Holdings By-Laws. The Reorganized Holdings Certificate of Incorporation will provide for, among other things, a Board, consisting of seven members, and one member of the Board of Reorganized Holdings shall include the Chief Executive Officer of Reorganized Holdings. NTFC will be allowed to appoint, at its option, either one voting member or one observing member of the Board of Reorganized Holdings. The initial board of Reorganized Holdings shall consist of the individuals identified on Exhibit F to this Plan. Such directors shall be deemed elected or appointed, as the case may be, pursuant to the Confirmation Order, but shall not take office and shall not be deemed to be elected or appointed until the occurrence of the Effective Date. The directors of each of the Subsidiary Debtor as of the Confirmation Date shall be the same as the Board of Reorganized Holdings. The officers of each Consolidated Debtor as of the date of the Confirmation Date shall be the officers of such Reorganized Debtor as of the Effective Date. Those directors of the Consolidated Debtors not continuing in office shall be deemed removed therefrom as of the Effective Date pursuant to the Confirmation Order.

9.8. Survival of Indemnification and Contribution Obligations. Notwithstanding anything to the contrary contained in this Plan, the obligations of the Debtors to indemnify and/or provide contribution to its directors, officers, agents, employees and representatives who are serving in such capacity on the Confirmation Date, pursuant to the Old Holdings Certificate of Incorporation, Old Holdings By-Laws, applicable statutes or contractual obligations, in respect of all past, present and future actions, suits, proceedings or claims against any of such directors, officers, agents, employees and representatives, based upon any act or omission related to service with, for or on behalf of the Debtors, whether occurring before or after the Effective

Date, shall not be discharged or Impaired by Confirmation or Consummation of this Plan, but rather shall survive unaffected by this Plan and the Confirmation Order.

9.9. Substantive Consolidation for Plan Purposes Only: Procedure.

- (a) Subject to Section 9.9(c), this Plan contemplates entry of the Confirmation Order effecting the substantive consolidation of the Chapter 11 Cases solely for the purposes of all actions associated with Confirmation and Consummation of the Consolidated Plan. On the Confirmation Date or such other date as may be set by a Final Order of the Bankruptcy Court, but subject to the occurrence of the Effective Date: (i) all Intercompany Claims shall be eliminated and extinguished; (ii) all pre-petition cross-corporate guarantees of the Consolidated Debtors shall be eliminated; (iii) any obligation of, and all guarantees thereof executed by, one or more of the Consolidated Debtors shall be deemed to be one obligation of the Consolidated Debtors; (iv) any Claims Filed or to be Filed in connection with any such obligation and such guarantees shall be deemed one Claim against the consolidated Debtors; (v) each and every Claim Filed in the individual Chapter 11 Case of any of the Consolidated Debtors shall be deemed Filed against the Consolidated Debtors in the consolidated Chapter 11 Cases of the Consolidated Debtors and shall be deemed, subject to the terms of the Consolidated Plan, a single obligation of all of the Consolidated Debtors on and after the Confirmation Date; and (vi) all duplicative Claims (identical in both amount and subject matter) Filed against more than one of the Consolidated Debtors will be automatically expunged (and without the need for the entry of any Order or the filing of any objection), so that only one Claim survives against the Consolidated Debtors, but in no way shall such Claim be deemed Allowed by reason of this Section 9.9. Notwithstanding the provisions of this Section 9.9 or any other provision of this Plan, each Consolidated Debtor shall, as a Reorganized Debtor, continue to exist after the Effective Date as a separate legal entity from all other Reorganized Debtors and shall retain title to all the Assets such Consolidated Debtor owned immediately prior to the Effective Date. Nothing in this Section 9.9 shall affect the legal and organizational structure of the Reorganized Debtors or limit, modify or otherwise affect the classification of Claims set forth in Article Five of this Plan and the different distributions each such Class is entitled to receive as set forth in Article Six of this Plan.
- (b) This Plan will serve as, and will be deemed to be, a motion for entry of the Confirmation Order, substantively consolidating, subject to the occurrence of the Effective Date, the Chapter 11 Cases for the purposes and subject to the terms of Section 9.9(a). Pursuant to Bankruptcy Rule 9019 and any applicable state law, and as consideration for the distributions, classifications of Claims, and other benefits provided under this Plan, the provisions of Section 9.9(a) shall constitute a compromise and settlement of any Cause of Action or disputes that could be brought by any Holder of a Claim or Equity Interest asserting that such Claim or Equity Interest would have received more favorable treatment had substantive consolidation not been effected. The Confirmation Order shall constitute the Bankruptcy Court's approval of such compromise and settlement and its finding

that this is a good faith compromise and settlement pursuant to applicable law, given and made after due notice and opportunity for a hearing, and shall bar any Cause of Action by any Holder of a Claim or Equity Interest with respect to any of the matters described in this Section 9.9.

- (c) Notwithstanding anything to the contrary contained herein, in the event that the Bankruptcy Court declines to substantively consolidate the Estate of Holdings with the Estates of the Subsidiary Debtors in the manner set forth in Section 9.9(a) or otherwise declines to confirm this Plan for Holdings, then the Alternative Plan shall be confirmed for the Subsidiary Debtors. Under the Alternative Plan:
- (1) Neither any Claims against Holdings (Including the Pre-Petition Note Claims and the Avaya Claim) nor the Old Holdings Equity Interest shall be discharged or otherwise affected by this Plan, except as provided in this Section 9.9(c);
  - (2) Allied's Liens against all Assets of Holdings securing the Allied Tranche B Claim and the Allied Tranche A Claim shall not be discharged or otherwise affected, except as provided in this Section 9.9(c);
  - (3) After the Confirmation Date but before the Effective Date, Holdings shall file a motion with the Bankruptcy Court under section 363 of the Bankruptcy Code to sell the Assets of Holdings, Including Holdings' stock in the Non-Debtor Subsidiaries (but not the Subsidiary Equity Interests), or Allied shall file a motion with the Bankruptcy Court for relief from the stay under section 362 of the Bankruptcy Code and the Final DIP Order to foreclose on its Liens on Holdings' Assets (excluding the Subsidiary Equity Interests) and to conduct a foreclosure sale of such Assets;
  - (4) At such section 363 or foreclosure sale, Allied may credit-bid its Claims under the DIP Facility Agreement as follows: first, Allied may credit-bid all or part of the Allied Tranche B Claim and, second, Allied may credit-bid all or part of the Allied Tranche A Claim;
  - (5) If Allied is the winning bidder at such sale and acquires the Assets of Holdings, Allied will, on or before the Effective Date, contribute all the Assets of Holdings that Allied acquires to Reorganized Holdings, and the following transactions shall be deemed to occur:
    - (i) The amount credit-bid by Allied shall be applied dollar-for-dollar, first, to reduce the Allowed amount of the Allied Tranche B Claim and, second, to reduce the Allowed amount of the Allied Tranche A Claim. The reduction in the amount of each of these Claims, expressed as a percentage of the original Allowed amount, shall be the Remaining Outstanding Percent of each such Claim.
    - (ii) The principal amount of the Modified Allied Secured Note shall be reduced by a percentage of \$7,500,000 equal to any percentage

reduction in the Allowed amount of the Allied Tranche B Claim pursuant to clause (i).

- (iii) The number of shares of New Preferred Stock to be issued to Allied under Section 6.2.2 of this Plan shall be reduced by a percentage equal to any percentage reduction of the Allowed amount of the Allied Tranche A Claim pursuant to clause (i).
  - (iv) The distributions to be received by Allied under Sections 2.3, 6.2.2, 6.2.3, and 6.3.2, as reduced and/or thereafter increased pursuant to Section 9.9(c)(5)(ii) and 9.9(c)(5)(iii), shall be deemed in settlement, release and discharge of the Satisfied Percent of the Allied Tranche B Claim and the Allied Tranche A Claim, respectively. Allied shall be deemed to have retained the Remaining Outstanding Percent of the Allied Tranche B Claim and the Allied Tranche A Claim, respectively, which it then credit-bid to acquire the assets of Holdings at the sale described above.
  - (v) In exchange for the Assets contributed to Reorganized Holdings, the principal amount of the Modified Allied Secured Note shall be increased by the amount by which it was reduced pursuant to clause (ii) and Allied shall receive the number of shares of New Preferred Stock equal to the amount of the reduction in such shares pursuant to clause (iii). As a result of the transactions contemplated by this Section 9.9(c)(5), Reorganized Holdings will have the same Assets as Holdings did immediately prior to Confirmation, and Allied will receive the same aggregate consideration for the Allied Tranche B Claim and the Allied Tranche A Claim as it would have received had the Consolidated Plan been confirmed.
- (6) If an Entity other than Allied is the winning bidder at such sale and acquires any Assets for Cash at such sale, then
- (i) Allied shall receive the net Cash proceeds of the sale up to the total Allowed amount of the Allied Tranche B Claim and the Allied Tranche A Claim.
  - (ii) The net Cash proceeds Allied receives shall be applied dollar-for-dollar, first, to reduce the Allowed amount of the Allied Tranche B Claim and, second, to reduce the Allowed amount of the Allied Tranche A Claim. The reduction in the amount of these Claims, expressed as a percentage of the original Allowed Amount, shall be the "Remaining Outstanding Percent" of each such Claim.
  - (iii) The principal amount of the Modified Allied Secured Note shall be reduced by a percentage of \$7,500,000 equal to any percentage reduction in the Allowed amount of the Allied Tranche B Claim pursuant to clause (iii).

- (iv) The number of shares of New Preferred Stock, to be issued to Allied under Section 6.2.2 of this Plan, shall be reduced by a percentage equal to any percentage reduction of the Allowed amount of the Allied Tranche A Claim pursuant to clause (ii).
  - (v) The distributions to be received by Allied as provided in Sections 2.3, 6.2.2, 6.2.3, and 6.3.2, as reduced pursuant to Section 9.9(c)(6)(iii) and (iv), shall be deemed in complete settlement, release and discharge of the Satisfied Percent of the Allied Tranche B Claim and the Allied Tranche A Claim, respectively. Allied shall be deemed to have retained the Remaining Outstanding Percent of the Allied Tranche B Claim and the Allied Tranche A Claim, respectively, which shall have been satisfied by the net Cash proceeds received in the sale under this Section 9.9(c).
- (d) Nothing herein shall result in the consolidation of the Non-Debtor Subsidiaries with the Consolidated Debtors or the Reorganized Debtors. Nor shall anything herein be construed to release or discharge any claims that any of the Reorganized Debtors has or may have against any Non-Debtor Subsidiary (and against Holdings, if the Alternative Plan is confirmed), all of which Claims shall be fully preserved.

9.10. Prior Ownership Changes. If the Alternative Plan is confirmed and, prior to the Effective Date, there has occurred an ownership change (as defined in section 382(g) of the Internal Revenue Code) with respect to the consolidated group of which Holdings is the common parent, and which includes any Subsidiary Debtor, a timely election shall be made by Holdings pursuant to section 1.1502-95 of the U.S. Treasury Regulations to apportion to the Subsidiary Debtors a portion of the consolidated section 382 limitation arising from each such prior ownership change. The amount of the consolidated section 382 limitation to be apportioned to the Subsidiary Debtors for each such prior ownership change shall be the lesser of (a) the total amount of the section 382 limitation arising from the prior ownership change or (b) the amount of the section 382 limitation arising from the ownership change occurring with respect to the Subsidiary Debtors in connection with the transactions effected pursuant to the Alternative Plan, as such amount is reasonably determined by New Holdings and set forth in a notice to Holdings prior to the time the apportionment election is to be made.

9.11. Satisfaction, Release and Extinguishment of DIP Loan Agreement. Subject to Section 9.9(c), this Plan and the distributions and benefits to be provided hereunder to Allied and NTFC are in full satisfaction of all Claims, Liens and other rights granted those parties under the DIP Loan Agreement, the Final DIP Order and any and all documents executed pursuant thereto. From and after the Effective Date, neither Allied nor NTFC shall have any further Claims, Liens or rights arising under the DIP Loan Agreement, the Final DIP Order and any and all documents executed pursuant thereto.

9.12. New Subsidiary Shares. In the event that the Alternative Plan is confirmed the New Subsidiary Stock shall be issued to New Holdings on (or as soon as reasonably practicable after) the Effective Date.

9.13. Mukunda Note and Claim Agreement. On the Effective Date, the Reorganized Debtors and Ram Mukunda will enter into and implement the Mukunda Note and Claim Agreement.

9.14. Executive Compensation.

- (a) The Senior Executive Employment Agreements shall be effective as of the Effective Date and such Senior Executive Employment Agreements shall supersede all employment agreements between the Debtors and Ram Mukunda and Prabhav V. Maniyar in effect prior to the Effective Date.
- (b) On the Effective Date, Reorganized Holdings shall institute the Employee Incentive Plan, which will provide for the issuance of the Employee Incentive Options.

9.15. Reorganized Debtors' Retention of Claims Against Other Entities. Except as otherwise expressly provided herein, pursuant to section 1123(b)(3) of the Bankruptcy Code, from and after the Effective Date, the Reorganized Debtors shall retain and shall have the exclusive right, in their discretion, to enforce against any Person any and all Causes of Action of the Consolidated Debtors, including all Causes of Action arising out of or relating to all Causes of Action of a trustee and debtor-in-possession under sections 542, 544, 545, 546, 547, 548, 549, 550, and 553 or otherwise under chapter 5 of the Bankruptcy Code. Unless a Cause of Action against any Entity is expressly waived, relinquished, released, compromised or settled as provided or identified in this Plan or any Final Order, the Consolidated Debtors expressly reserve all causes of action for later adjudication and, therefore, no preclusion doctrine, including the doctrines of res judicata, collateral estoppel, issue preclusion, claim preclusion, estoppel (judicial, equitable or otherwise) or laches, shall apply to such causes of action upon or after the Confirmation or Consummation of this Plan.

ARTICLE TEN  
PROVISIONS COVERING DISTRIBUTIONS

10.1. Cash Payments. Any Cash payment to be made pursuant to this Plan may be made, at the option of the Reorganized Debtors, by draft, check, wire transfer, or as otherwise required or provided in any relevant agreement or applicable law. Cash payments to foreign Creditors may be made, at the option of the Reorganized Debtors, in such funds and by such means as are necessary or customary in a particular foreign jurisdiction. Cash payments made pursuant to this Plan in the form of checks shall be null and void if not cashed within 120 days of the date of the issuance thereof. Requests for reissuance of any check shall be made directly to the Reorganized Debtors as set forth in Section 10.7 below.

10.2. Payment of Statutory Fees. All fees payable pursuant to 28 U.S.C. § 1930 that are due through the Effective Date shall be paid by the Debtors and any such fees payable by the Reorganized Debtors thereafter shall be paid by the Reorganized Debtors as and when due.

10.3. No Interest. Except with respect to Holders of Unimpaired Claims to the extent they are entitled to interest under applicable law or as otherwise expressly provided herein, no Holder of an Allowed Claim or Equity Interest shall receive interest on the distribution to which



such Holder is entitled hereunder, regardless of whether such distribution is made on the Effective Date or thereafter.

10.4. Fractional Securities. Notwithstanding any other provision of this Plan, only whole numbers of shares of New Common Stock will be issued or transferred, as the case may be, pursuant to this Plan. Reorganized Holdings will not distribute any fractional shares of New Common Stock under this Plan. For purposes of distribution, fractional shares of New Common Stock shall be rounded down to the nearest whole share of New Common Stock.

10.5. Withholding of Taxes. The Reorganized Debtors may withhold from any property distributed under this Plan any property that is subject to withholding for taxes payable by the Entity entitled to such property to the extent required by applicable law. As a condition to making any distribution under this Plan, the Reorganized Debtors or their designee, as the case may be, may request that the Holder of any Allowed Claim provide such Holder's taxpayer identification number and such other certification as may be deemed necessary to comply with applicable tax reporting and withholding laws.

10.6. Surrender of Instruments. As a condition to receiving any distribution under this Plan, at the election of the Reorganized Debtors, each Holder of an Instrument evidencing a Claim must surrender such Instrument to Reorganized Holdings or its designee. Any Holder of a Claim that fails to (a) surrender such Instrument or (b) execute and deliver an affidavit of loss and/or indemnity reasonably satisfactory to Reorganized Holdings or its designee before the later to occur of (i) six months following the Effective Date and (ii) three months following the date such Holder's Claim becomes an Allowed Claim, shall be deemed to have forfeited all rights, Claims, and/or Equity Interests and may not participate in any distribution under this Plan. Upon timely compliance with this Section 10.6, the Holder of a Claim or Equity Interest evidenced by any such lost, stolen, mutilated or destroyed Instrument will, for all purposes under this Plan, be deemed to have surrendered such Instrument.

10.7. Undeliverable or Unclaimed Distributions. In accordance with section 347(b) of the Bankruptcy Code, any Entity that is entitled to receive a Cash distribution under this Plan but that fails to cash a check within 120 days of its issuance shall be entitled to receive a reissued check from the Reorganized Debtors for the amount of the original check, without any interest, if such Entity requests in writing the Reorganized Debtors to reissue such check and provides the Reorganized Debtors with such documentation as the Reorganized Debtors request to verify in their reasonable discretion that such Entity is entitled to such check, prior to the later to occur of (i) the first anniversary of the Effective Date and (ii) six months following the date such Holder's Claim becomes an Allowed Claim. If an Entity fails to cash a check within 120 days of its issuance and fails to request reissuance of such check prior to the later to occur of the dates specified in clause (i) and (ii) of the immediately prior sentence, such Entity shall not be entitled to receive any further distribution under this Plan. If the distribution to any Holder of an Allowed Claim is returned to the Reorganized Debtors as undeliverable, no further distributions will be made to such Holder unless and until the Reorganized Debtors or their designee are notified in writing of such Holder's then-current address. After the second anniversary of the Effective Date, all unclaimed property shall revert to the Reorganized Debtors and the claim of any Holder or successor to such Holder with respect to such property shall be discharged and forever barred notwithstanding any federal or state escheat laws to the contrary.

10.8. Effect of Foreign Proceedings. If any Entity receives, in a foreign proceeding, payment of, or a transfer of property on account of, an Allowed Claim, such Entity may not receive any payment under this Plan on account of such Claim until each of the other Holders of Claims in the same Class has received under this Plan distributions, based on such other Holders' Pro Rata Share, equal in value to the consideration received by such Entity in the foreign proceeding.

10.9. Distributions to Holders of Class 4 Claims.

- (a) All distributions (if any) of New Common Stock on account of Class 4 Pre-Petition Note Claims shall be made to the Indenture Trustee for further distribution to individual Holders of Class 4 Pre-Petition Note Claims. Any such distribution of New Common Stock by the Indenture Trustee shall be made pursuant to the terms of this Plan and the Indenture. The Indenture Trustee shall be solely responsible for all stock distributions to Holders of Allowed Prepetition Note Claims and no such Holder shall have any claim against the Reorganized Debtors for any act or omissions of the Indenture Trustee. Notwithstanding any provision in this Plan to the contrary, the Indenture shall continue in effect to the extent necessary to allow the Indenture Trustee to receive and make distributions pursuant to this Plan on account of Class 4 Pre-Petition Note Claims. Any actions taken by the Indenture Trustee on or after the Effective Date that are not for this purpose shall be null and void as against the Reorganized Debtors and the Reorganized Debtors shall have no obligations to the Indenture Trustee for any fees, costs and expenses incurred in connection with any such action.
- (b) As of the close of business on the Distribution Record Date, the transfer ledgers for the Pre-Petition Notes shall be closed, and there shall be no further changes in the record holders of any Pre-Petition Notes. The Reorganized Debtors and the Indenture Trustee shall have no obligation to recognize any transfer of Pre-Petition Notes occurring on or after the Distribution Record Date. The Reorganized Debtor and the Indenture Trustee shall instead be entitled to recognize for all purposes hereunder only those Holders listed on the transfer ledgers of the Indenture Trustee as of the close of business on the Distribution Record Date. In the event of any dispute regarding the identity of any Entity entitled to any payment or distribution in respect of any Claim under this Plan, no distributions will be made in respect of such Claim until the Bankruptcy Court resolves that dispute pursuant to a Final Order. As soon as reasonably practicable after the Distribution Record Date, the Indenture Trustee shall provide the Consolidated Debtors with a list of the record holders (as of the Distribution Record Date) of any Pre-Petition Notes, the address of such record holders, and the principal amount of Pre-Petition Notes held by such record holders.

10.10. Setoffs.

- (a) The Consolidated Debtors may, but shall not be required to, set off against any Claim, and the payments or other distributions to be made pursuant to this Plan in respect of such Claim, claims (whether arising before, on or after the Filing Date

or the Effective Date) of any nature whatsoever that the Consolidated Debtors may have against the holder of such Claim; but neither the failure to do so nor the allowance of any Claim hereunder shall constitute a waiver or release by the Consolidated Debtors of any such claim that the Consolidated Debtors may have against such Holder.

- (b) Nothing herein, Including any substantive consolidation of the Chapter 11 Cases for purposes of distribution contemplated by Section 9.9, is intended or shall be construed to limit or otherwise affect any claims, defenses or rights of any Debtor with respect to setoff or recoupment. The Consolidated Debtors expressly reserve all such claims, defenses and rights with respect to setoff and recoupment.
- (c) Any Holder of a Pre-Petition Claim against any of the Consolidated Debtors who asserts a right of setoff against any debt owing to any of the Consolidated Debtors that arose before the Filing Date must assert such right of setoff in a timely filed Proof of Claim or, to the extent such Proof of Claim is not required to preserve such right of setoff under applicable law, within ninety (90) days of the Effective Date, or such right of setoff shall be forever barred.

#### ARTICLE ELEVEN PROCEDURES FOR RESOLVING DISPUTED CLAIMS

11.1. Objections to Claims. Only the Consolidated Debtors or, after the Effective Date, the Reorganized Debtors shall have the authority to File, settle, compromise, withdraw or litigate to judgment objections to Claims. The Consolidated Debtors or the Reorganized Debtors, as the case may be, may object to a Claim by filing an objection with the Bankruptcy Court and serving such objection upon the Holder of such Claim on or before the Claims Objection Deadline.

11.2. Litigation and Settlement of Objections. Unless otherwise ordered by the Bankruptcy Court or agreed to by written stipulation of the Consolidated Debtors or the Reorganized Debtors, or until an objection thereto by the Consolidated Debtors or by Reorganized Debtors is withdrawn, the Debtors or the Reorganized Debtors shall litigate the merits of each Disputed Claim until determined by a Final Order; provided, however, that, (a) prior to the Effective Date, the Consolidated Debtors, subject to the approval of the Bankruptcy Court, and (b) after the Effective Date, the Reorganized Debtors, without approval of the Bankruptcy Court may withdraw, compromise and/or settle any objection to any Claim, Including any Claim for Administrative Expenses.

11.3. Payments and Distributions With Respect to Disputed Claims. No payments or distributions shall be made in respect of any Disputed Claim (or any disputed Administrative Expense) until such Disputed Claim (or disputed Administrative Expense) becomes an Allowed Claim (or any Allowed Administrative Expense). Distributions to each Holder of a Claim, to the extent that such Claim ultimately becomes an Allowed Claim or Allowed Administrative Expense, will be made, without interest, in accordance with the provisions of this Plan.

11.4. Reserve. If Class 3A votes to accept this Plan, the Reorganized Debtors shall maintain in reserve the New Common Stock that would be distributed to Holders of Disputed

Claims in Class 3A if any or all such Claims were Allowed. If Class 3A, Class 3C, and Class 4 vote to accept this Plan, and the Consolidated Plan is confirmed, the Reorganized Debtors shall maintain in reserve the New Common Stock that would be distributed to Holders of Disputed Claims (if any) in Class 4 if any or all such Claims were Allowed.

11.5. Estimation. For purposes of effectuating this Plan (Including Section 11.4) and the allocations and distributions to Holders of Allowed General Unsecured Claims, the Bankruptcy Court may, pursuant to section 502 of the Bankruptcy Code, by estimation or otherwise, fix or liquidate the amount of any contingent or unliquidated General Unsecured Claim, in which event the amount so fixed will be deemed the Allowed amount of such Claim for purposes of this Plan or, in lieu thereof, the Bankruptcy Court may determine the maximum contingent or unliquidated amount for such Claim, which amount shall be the maximum amount in which such Claim ultimately may be Allowed under this Plan, if such Claim is Allowed in whole or part. The Bankruptcy Court's determination may limit the distribution to be made on individual Disputed Claims, regardless of the amount finally Allowed on account of such Disputed Claims, and no Holder shall have recourse against the Reorganized Debtors or any of their respective professional consultants, attorneys, advisors, officers, directors or members or their successors or assigns, or any of their respective property on account thereof.

11.6. Distributions After Disallowance of Disputed General Unsecured Claims. If Class 3A votes to accept this Plan, Holders of Allowed General Unsecured Claims in Class 3A that receive an initial distribution after Allowance of such Holder's General Unsecured Claim, may receive subsequent distributions if and to the extent that other General Unsecured Claims that, if Allowed, would be in Class 3A are disallowed or expunged, as follows: as soon as reasonably practicable following each Catch-Up Distribution Date, each Holder of an Allowed General Unsecured Claim that has previously received any New Common Stock pursuant to Section 6.3.1 or 11.3 of this Plan, shall receive a distribution on New Common Stock in an amount equal to the difference, if any, between (i) the number of shares of New Common Stock representing such Holder's aggregate Pro Rata Share of the Unsecured Stock Distribution as of such Catch-Up Distribution Date and (ii) the aggregate number of shares of New Common Stock previously distributed to such Holder under Section 6.3.1 or 11.3 of this Plan. If Class 3A, Class 3C, and Class 4 vote to accept this Plan, and the Consolidated Plan is confirmed, and to the extent there are Disputed Claims in Class 4, the Reorganized Debtors shall implement similar provisions for subsequent distributions from the New Common Stock held in reserve for disputed Claims in Class 4 pursuant to Section 11.4 of this Plan, to Holders of Allowed Pre-Petition Notes Claims in accordance with Section 6.3.4 of this Plan upon the disallowance of any Disputed Pre-Petition Note Claim.

## ARTICLE TWELVE

### EFFECT OF THIS PLAN ON CLAIMS AND INTERESTS

#### **12.1. Discharge of All Claims and Equity Interests and Releases.**

- (a) **Except as otherwise specifically provided by this Plan, Confirmation of this Plan (subject to the occurrence of the Effective Date) shall discharge and release the Consolidated Debtors, the Reorganized Debtors, their successors and assigns and their respective Assets and properties from any debt, charge,**

Cause of Action, liability, Lien, encumbrance, security interest, Claim, Interest, or other cause of action of any kind, nature or description (Including any claim of successor liability) that arose before the Confirmation Date, and any debt of the kind specified in sections 502(g), 502(h) or 502(i) of the Bankruptcy Code, whether or not a Proof of Claim or Interest is or could have been Filed or is deemed Filed, whether or not such Claim or Interest is or could have been Allowed, and whether or not the Holder of such Claim or Interest voted or could have voted to accept or reject this Plan.

- (b) Except as otherwise specifically provided by this Plan or the Confirmation Order, effective as of the Effective Date, none of the Debtor Releasees, the Committee Releasees, the Allied Releasees or the NTFC Releasees shall have any responsibility, or have or incur any liability, to any Entity whatsoever (i) for any matter expressly approved or directed by the Confirmation Order or (ii) under any theory of liability (except for any claim based upon willful misconduct or gross negligence) for any act taken or omission made in good faith directly related to formulating, implementing, confirming, or consummating this Plan, the Disclosure Statement, or any Plan Document; provided that nothing in this Section 12.1 shall limit the liability of any Entity for breach of any express obligation it has under this Plan, the Plan Documents, or any other documents executed in connection herewith or therewith or pursuant hereto or thereto, or under any other agreement or document entered into by such Entity in accordance with or pursuant to the terms of this Plan, except to the extent expressly provided herein or for any breach of a duty of care owed to any other Entity occurring after the Effective Date.
- (c) On the Effective Date, each of the Consolidated Debtors shall release unconditionally, and hereby is deemed to release unconditionally, (i) each of the Debtor Releasees (sole in their capacities as such), (ii) the Creditors Committee and, solely in their capacity as members or representatives of the Creditors Committee, the Committee Releasees, (iii) the Allied Releasees, and (iv) the NTFC Releasees from any and all claims, obligations, suit, judgments, damages, rights, causes of action and liabilities whatsoever, whether known or unknown, foreseen or unforeseen, existing or hereafter arising, in law, equity or otherwise, based in whole or in part upon any act or omission, transaction, event or other occurrence taking place on or after the Filing Date and up to and including the Effective Date in any way relating to the Chapter 11 Cases, this Plan or the Disclosure Statement.

12.2. **Injunction.** The satisfaction, release and discharge pursuant to Sections 12.1 and 12.3 of this Plan, shall act as an injunction against any Entity commencing or continuing any action, employment of process, or act to collect, offset or recover any Claim or Cause of Action satisfied, released or discharged under this Plan. The injunction, discharge and releases described in Sections 12.1, 12.2 and 12.3 of this Plan shall apply regardless of whether or not a Proof of Claim or Interest based on any Claim, debt, liability

or Interest is Filed or whether or not a Claim or Interest based on such Claim, debt, liability or Interest is Allowed, or whether or not such entity voted to accept or reject this Plan. Without in any way limiting the foregoing, all injunctions or stays entered in these Chapter 11 Cases and existing immediately prior to the Confirmation Date shall remain in full force and effect until the Effective Date.

12.3. **Exculpation.** On the Effective Date, and in consideration of the distributions to be received under this Plan, (i) each Holder of a Claim or Interest who has voted to accept this Plan shall be deemed to have unconditionally released the Debtor Releasees, the Committee Releasees, the Allied Releasees and the NTFC Releasees from any and all claims, obligations, suits, judgments, damages, rights, Causes of Action and liabilities whatsoever which any such Holder may be entitled to assert, whether known or unknown, foreseen or unforeseen, existing or hereafter arising, in law, equity or otherwise, based in whole or in part upon any act or omission, transaction, event or other occurrence taking place on or after the Filing Date and up to and including the Effective Date in any way relating to the Chapter 11 Cases, this Plan or the Disclosure Statement, excepting, however, from such release any obligation owing to a holder of an Allowed Claim or Allowed Interest arising under this Plan; and (ii) each Holder of a Claim or Interest shall be deemed to have unconditionally released the Debtor Releasees, the Committee Releasees, the Allied Releasees and the NTFC Releasees from any and all Claims, obligations, suits, judgments, damages, rights, Causes of Action and liabilities whatsoever which any such Holder may be entitled to assert, whether known or unknown, foreseen or unforeseen, existing or hereafter arising, in law, equity or otherwise, based in whole or in part upon any act or omission, transaction, event or other occurrence taking place on or after the Filing Date and up to and including the Effective Date for which released rights the Holder is entitled to a Claim or Interest that receives or retains value as provided in the Plan.

**ARTICLE THIRTEEN**  
**CONDITIONS PRECEDENT TO CONFIRMATION ORDER**  
**AND EFFECTIVE DATE**

13.1. **Conditions Precedent to Entry of the Confirmation Order.** The Confirmation Order must be in form and substance acceptable to the Consolidated Debtors, Allied and NTFC for this Plan to be confirmed on the Confirmation Date.

13.2. **Conditions Precedent to the Effective Date.** The following conditions must occur and be satisfied or waived by the Consolidated Debtors, Allied and NTFC, on or before the Effective Date for this Plan to become effective on the Effective Date.

- (a) **Confirmation Order.** The Confirmation Order shall have been entered by the Bankruptcy Court and no stay of the Confirmation Order shall have been entered and remain in effect.
- (b) **Authorizations, Consents and Approvals.** All authorizations, consents and regulatory approvals from any Governmental Unit required to be obtained by the Consolidated Debtors, if any, in connection with this Plan's effectiveness shall have been obtained.

- (c) Sale Pursuant to Alternative Plan. If the Alternative Plan is confirmed, the sale described in Section 9.9(c) shall have occurred and, to the extent that Allied acquires Assets of Holdings as the successful bidder in such sale, Allied shall have contributed those Assets to Reorganized Holdings.

13.3. Effect of Failure of Conditions. If all the conditions to effectiveness and the occurrence of the Effective Date have not been satisfied or waived by the Consolidated Debtors, Allied and NTFC in a writing filed with the Bankruptcy Court on or before the first Business Day that is more than 120 days after the Confirmation Date, then, at the election and upon motion of the Consolidated Debtors made before the time that all of the conditions have been satisfied or so duly waived, the Confirmation Order shall be vacated by the Bankruptcy Court; provided, however, that notwithstanding the filing of such a motion, the Confirmation Order shall not be vacated if all of the conditions to Consummation set forth in Section 13.2 are either satisfied or duly waived before the Bankruptcy Court enters an order granting the relief requested in such motion.

#### ARTICLE FOURTEEN RETENTION OF JURISDICTION

14.1. Bankruptcy Court to Retain Jurisdiction. The business and Assets of the Consolidated Debtors shall remain subject to the jurisdiction of the Bankruptcy Court until the Effective Date. From and after the Effective Date, the Bankruptcy Court shall retain and have jurisdiction of all matters arising out of, and related to the Chapter 11 Cases of the Consolidated Debtors or this Plan pursuant to, and for purposes of, sections 105(a) and 1142 of the Bankruptcy Code and for, among other things, the following purposes: On and after the Effective Date, the Bankruptcy Court shall retain jurisdiction over all matters arising in, arising under, or related to the Chapter 11 Cases of the Consolidated Debtors for, among other things, the following purposes:

- (a) To hear and determine applications for the assumption or rejection of executory contracts or unexpired leases and the allowance of Claims resulting therefrom.
- (b) To determine any motion, adversary proceeding, avoidance action, application, contested matter, and other litigated matter pending on or commenced after the Confirmation Date.
- (c) To ensure that distributions to holders of Allowed Claims are accomplished as provided herein.
- (d) To consider Claims or the allowance, classification, priority, compromise, estimation, or payment of any Pre-Petition Claim or other Claim, Administrative Expense, or Equity Interest.
- (e) To consider any objections to a Claim asserted against any of the Consolidated Debtors and any counterclaims asserted by the Reorganized Debtors thereto.

- (f) To enter, implement, or enforce such orders as may be appropriate in the event the Confirmation Order is for any reason stayed, reversed, revoked, modified, or vacated.
- (g) To issue injunctions, enter and implement other orders, and take such other actions as may be necessary or appropriate to restrain interference by any Person with the consummation, implementation, or enforcement of this Plan, the Confirmation Order, or any other order of the Bankruptcy Court.
- (h) To hear and determine any application to modify this Plan in accordance with section 1127 of the Bankruptcy Code, to remedy any defect or omission or reconcile any inconsistency in this Plan, the Disclosure Statement, or any order of the Bankruptcy Court, including the Confirmation Order, in such a manner as may be necessary to carry out the purposes and effects thereof.
- (i) To hear and determine all Fee Claims.
- (j) To hear and determine disputes arising in connection with the interpretation, implementation, or enforcement of this Plan, the Confirmation Order, any transactions or payments contemplated hereby, or any agreement, instrument, or other document governing or relating to any of the foregoing.
- (k) To take any action and issue such orders as may be necessary to construe, enforce, implement, execute, and consummate this Plan, including any release or injunction provisions set forth herein, or to maintain the integrity of this Plan following consummation.
- (l) To determine such other matters and for such other purposes as may be provided in the Confirmation Order.
- (m) To hear and determine matters concerning state, local, and federal taxes in accordance with sections 346, 505, and 1146 of the Bankruptcy Code.
- (n) To hear any Causes of Action preserved under Sections 9.9(d) and 9.15 of this Plan asserted by the Reorganized Debtors, to the extent permitted by law.
- (o) To hear and determine any other matters related hereto and not inconsistent with the Bankruptcy Code and title 28 of the United States Code.
- (p) To enter a final decree closing the Reorganization Cases.
- (q) To recover all Assets of the Debtors and property of the Estates, wherever located.

In the event that the Alternative Plan is confirmed, the Bankruptcy Court shall retain jurisdiction over the Chapter 11 Cases of Holdings to the fullest extent provided in 28 U.S.C. §§ 157 and 1334.



ARTICLE FIFTEEN  
MISCELLANEOUS PROVISIONS

15.1. Nonvoting Stock. In accordance with section 1123(a)(6) of the Bankruptcy Code, the Reorganized Holdings Certificate of Incorporation shall contain a provision prohibiting the issuance of nonvoting equity securities.

15.2. Withdrawal of this Plan. The Debtors reserve the right, at any time prior to the entry of the Confirmation Order, to revoke or withdraw this Plan. If the Debtors revoke or withdraw this Plan, if the Confirmation Date does not occur, or if the Confirmation Order is vacated pursuant to Section 13.3, or if the Effective Date does not occur, then (i) this Plan, any settlement or compromise embodied in this Plan (Including the fixing or limiting to an amount certain any Claim or Class of Claims), the assumption or rejection of executory contracts or leases effected by this Plan, and any document or agreement executed pursuant to this Plan, will be deemed null and void; (ii) this Plan shall be of no effect and shall be deemed vacated, and the Chapter 11 Cases shall continue as if this Plan had never been Filed and, in such event, the rights of any Holder of a Claim or Equity Interest shall not be affected nor shall such Holder be bound by, for purposes of illustration only, and not limitation, (a) this Plan, (b) any statement, admission, commitment, valuation or representation contained in this Plan or the Disclosure Statement or (c) the classification and proposed treatment (Including any allowance) of any Claim in this Plan; and (iii) nothing contained in this Plan or in the Disclosure Statement shall be deemed an admission or statement against interest or to constitute a waiver or release of any claims by or against any Debtor or any other Entity or to prejudice in any manner the rights of any Debtor or any Entity in any further proceedings involving any Debtor or any Entity.

15.3. Captions. Article and Section captions used in this Plan are for convenience only and will not affect the construction of this Plan.

15.4. Method of Notice. All notices required to be given under this Plan, if any, shall be in writing and shall be sent by facsimile transmission (with hard copy to follow), by first class mail, postage prepaid, by hand delivery or by overnight courier to:

If to a Debtor:

Startec Global Communications Corporation  
1151 Seven Locks Road  
Potomac, Maryland 20854  
Attn: Jeffrey L. Poersch, Esq.  
Fax No.: (240) 314-4219

with copies to:

Wilmer Cutler Pickering  
2445 M Street, N.W.  
Washington, D.C. 20037  
Attn: Philip D. Anker, Esq.  
Fax No.: (202) 663-6363

If to Allied:

Allied Capital Corporation  
1919 Pennsylvania Avenue, N.W.  
Third Floor  
Washington, D.C. 20005-3434  
Attn: Mr. Scott Binder  
Fax No.: (202) 659-2053

With copies to:

Dickstein Shapiro Morin & Oshinsky LLP  
2102 L. Street, N.W.  
Washington, D.C. 20037  
Attn: David Parker, Esq.  
Fax No.: (202) 887-0689

If to NTFC:

GE Capital, Telecom Financial Services  
10 Riverview Drive  
Danbury, Connecticut 06810  
Attn: Robert W. Wotten

With copies to:

Hunton Williams  
Riverfront Plaza, East Tower  
951 East Byrd Street  
Richmond, Virginia 23219-4074  
Attn: Peter S. Partee, Esq.  
Fax No.: (804) 788-8218

Any of the above may, from time to time, change its address for future notices and other communications hereunder by filing a notice of the change of address with the Bankruptcy Court. Any and all notices given under this Plan shall be effective when received.

15.5. Dissolution of the Committee. On the Effective Date, as to the Chapter 11 Cases of the Consolidated Debtors, the Creditors' Committee shall cease to exist and its members and employees or agents (Including any attorneys, investment bankers, financial advisors, accountants and other Professionals employed) shall cease from all further duties, responsibilities and obligations relating to and arising from and in connection with these Chapter 11 Cases and shall have no right to compensation for any further actions taken; provided, however, that following the Effective Date, the responsibilities of the Creditors' Committee and its members

and employees or agents shall be limited to the preparation of their respective fee applications, if any.

15.6. Amendments and Modifications to Plan. This Plan may be altered, amended or modified by the Debtors, before or after the Confirmation Date, as provided in section 1127 of the Bankruptcy Code, with the consent of the Debtors, Allied and NTFC.

15.7. Section 1125(e) of the Bankruptcy Code.

- (a) **The Debtors (and each of their respective Affiliates, agents, directors, officers, employees, advisors and attorneys) have, and upon Confirmation of this Plan shall be deemed to have, solicited acceptances of this Plan in good faith and in compliance with the applicable provisions of the Bankruptcy Code.**
- (b) **The Debtors (and each of their respective Affiliates, agents, directors, officers, employees, advisors, and attorneys) have, and upon confirmation of this Plan shall be deemed to have, participated in good faith and in compliance with the applicable provisions of the Bankruptcy Code with regards to the distributions of the Modified Allied Secured Note, Modified NTFC Secured Note, the Modified NTFC Junior Note, the New Preferred Stock, the New Common Stock, the New Warrant, the Employee Incentive Plan, and any new employee contracts under this Plan, and therefore are not, and on account of such distributions will not be, liable at any time for the violation of any applicable law, rule, or regulation governing the solicitation of acceptances or rejections of this Plan or such distributions made pursuant to this Plan.**

15.8. Exemption from Securities Registration. To the maximum extent provided by section 1145 of the Bankruptcy Code and applicable non-bankruptcy laws, the New Common Stock, the New Preferred Stock, the New Subsidiary Stock and the New Warrant issued pursuant to this Plan shall be exempt from registration under the Securities Act of 1933, as amended.

15.9. Business Days. If the Effective Date or any other date on which a transaction or deadline may occur under this Plan shall occur on a day that is not a Business Day, the transaction or deadline contemplated by this Plan to occur on such day shall instead occur on the next succeeding Business Day.

Dated: June 14, 2002

Respectfully submitted,

STARTEC GLOBAL COMMUNICATIONS CORPORATION  
STARTEC GLOBAL OPERATING COMPANY  
STARTEC GLOBAL LICENSING COMPANY

Debtors and Debtors-In-Possession

By: \_\_\_\_\_

Name: Ram Mukunda

Title: President and Chief Executive Officer

# EXHIBIT A

## Terms of Modified Debt

<b>Debtors</b>	Startec Global Communications Corporation (the "Holdings"), Startec Global Operating Company ("Operating"), and Startec Global Licensing Company ("Licensing"), each a Delaware corporation. (Newco if Alternative Plan adopted.)
<b>Co-Debtors</b>	All subsidiaries of Debtors, except where prohibited by national insolvency laws.
<b>Lenders</b>	Allied Capital Corporation, a Maryland corporation ("Allied"), and NTFC Capital Corporation, a Delaware corporation ("NTFC").
<b>Senior Notes</b>	\$7,500,000 to Allied <sup>1</sup> \$27,500,000 to NTFC
<b>Junior Notes</b>	\$8,000,000 to NTFC
<b>Maturity Date</b>	5 years
<b>Interest Rate</b>	10% per annum
<b>Payments</b>	<p>Payments of principal and interest will be made quarterly for three years, commencing with the first full calendar quarter after the Effective Date of the Plan. Payments will be made only to the extent of Excess Cash Flow generated by the Debtors for the quarter. Payments will be applied in the following order:</p> <ol style="list-style-type: none"><li>(1) to accrued and unpaid interest on the Senior Notes from prior quarters;</li><li>(2) to interest on the amount in (1) accrued during the current quarter;</li><li>(3) to interest on the Senior Notes accrued during the current quarter;</li><li>(4) to principal on the Senior Notes until the Senior Notes are</li></ol>

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<sup>1</sup> Subject to adjustment under the Plan.

- fully paid;
- (5) to accrued and unpaid interest on the Junior Note from prior quarters;
  - (6) to interest on the amount in (5) accrued during the current quarter;
  - (7) to interest on the Junior Notes accrued during the current quarter;
  - (8) to principal on the Junior Notes until the Junior Notes are fully paid.

Excess Cash Flow will equal EBITDA for a quarter after adjusting for non-cash items, less an allowance for working capital, budgeted capital expenditures and permitted payments (e.g., other permitted indebtedness, and capitalized lease obligations).

The aggregate outstanding amount of principal and interest at the end of the three year period above will be amortized and paid in equal installments of principal over the last eight quarters, together with interest thereon.

To the extent not previously paid during the first three years following the execution of the Notes, the Junior Note and all interest accrued thereon will be paid in full no later than the Maturity Date.

#### **Security Interest**

First lien on all assets of the Debtors, other than those granted to other persons pursuant to the Plan. The existing security interest in foreign assets under the DIP Facility will likewise secured the Notes, except to the extent prohibited by national insolvency laws.

#### **Deposit Accounts**

All receivables shall be payable into an account or accounts under the control of the Lenders.

#### **Lien Priority**

Upon the foreclosure or other liquidation of the collateral secured, Allied will have the first priority to the extent of its Senior Note, thereafter to NTFC on account of its Senior Note and finally to NTFC on account of its Junior Note.

#### **Covenants**

Capital Expenditure limitations will be operative during the entire term. Financial covenants (at least minimum revenues, EBITDA Margin and Debt Service Ratio) will apply commencing on the later of January 1, 2006 or the 1st day of the 13th full calendar quarter following the Effective Date, based upon the Debtors' current five-year plan.

#### **Events of Default**

Those typically found in credit agreements of this type.

# **EXHIBIT B**

## **Form of Warrant Agreement**

## COMMON STOCK PURCHASE WARRANT

Startec Global Communications Corporation<sup>2</sup>

1,750,000 Shares

THIS COMMON STOCK PURCHASE WARRANT (collectively with all amendments, renewals, extensions and replacements, this *Warrant*) is issued as of \_\_\_\_\_, 2002 by **Startec Global Communications Corporation** a Delaware corporation (hereinafter, the *Company*), to **NTFC Capital Corporation**, a Delaware corporation or its registered assigns (hereinafter, *Holder*). The Company hereby grants and agrees as set out herein, to and for the benefit of Holder.

1. **Definitions.** For purposes hereof, the following terms shall have the meanings set out below. Capitalized terms not otherwise defined herein shall have the meanings set forth in the Credit Agreement identified below.

(a) *Common Stock* is defined as the common stock, \$ .001 par value per share, of the Company.

(b) *Credit Agreement* is defined as the Amended and Restated Credit Agreement among the Company, the Holder and certain other parties, dated the date hereof, collectively with all amendments, renewals, extensions and replacements thereof and therefor.

(c) *Fair Market Value* is defined, as to any property on any relevant date, the fair market value of such property. Such value will be the value of such property reasonably determined by the Board of Directors of the Company and reasonably acceptable to the Holder, but if the Holder has not so accepted such determination within 10 business days of the date notice of such determination is delivered to the Holder, then such value will be determined by an independent investment banking firm selected by the Holder and reasonably acceptable to the Company. If the Fair Market Value determined by such investment banking firm exceeds the Fair Market Value determined by the Board of Directors by 10% or more, the cost of the engagement of the investment banking firm will be borne by the Company; otherwise such cost will be borne by the Holder.

(d) *Market Price* is defined, as to any security on any relevant date, as the Fair Market Value per share of such security, or if there shall be a public market for such security, the average of the daily closing prices for the ten (10) consecutive trading days before such date excluding any trades which are not bona fide arm's length transactions. The closing price for each day shall be (a) if such security is listed or admitted for trading on any national securities exchange, the last sale price of such security, or the mean of the closing bid and asked prices thereof if no such sale occurred, in each case as officially reported on the principal securities exchange on which such security is listed; or (b) if quoted on NASDAQ or any similar system of automated dissemination of quotations of securities prices then in common use, the mean between the closing high bid and low asked quotations of such security in the over-the-counter

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<sup>2</sup> Name of issuer will be conformed as necessary if Alternative Plan is confirmed.



market as shown by NASDAQ or such similar system of automated dissemination of quotations of securities prices, as reported by any member firm of the New York Stock Exchange selected by the Company; (c) if not quoted as described in clause (b), the mean between the high bid and low asked quotations for the Common Stock as reported by NASDAQ or any similar successor organization, as reported by any member firm of the New York Stock Exchange selected by the Company. If such security is quoted on a national securities or central market system in lieu of a market or quotation system described above, the closing price shall be determined in the manner set forth in clause (a) of the preceding sentence if bid and asked quotations are reported but actual transactions are not, and in the manner set forth in clause (b) of the preceding sentence if actual transactions are reported.

(e) *Significant Corporate Event* is defined as (a) any sale, transfer or lease of all or substantially all of the Company's assets, a merger or consolidation involving the Company in each case in which the Common Stock will be converted into the right to receive cash or new securities of the surviving corporation, (b) any tender or exchange offer in which the Company repurchases more than 10% of the then issued and outstanding shares of Common Stock capital stock, or (c) adoption of a plan of liquidation or dissolution of the Company.

(f) *Warrant Number* is defined as the number of Warrant Shares; the Warrant Number initially shall be as set out in paragraph 2 hereof, but shall be subject to certain adjustments from time to time as further provided herein.

(g) *Warrant Shares* is defined as the Common Stock shares issued or issuable hereunder, referred to collectively.

2. **Grant.** The Company, for value received, hereby grants to Holder, or its nominee, under the terms herein, the right to purchase One Million, Seven Hundred Fifty Thousand (**1,750,000**) of the fully paid and non-assessable shares of the Company's authorized but unissued Common Stock.

3. **Plan of Reorganization.** This Warrant is issued pursuant to the Debtors' Joint Plan of Reorganization of Startec Global Communications Corporation et al. Under Chapter 11 Of The Bankruptcy Code (the *Plan*), dated as of \_\_\_\_\_, 2002, as modified and confirmed by the Findings of Fact, Conclusions of Law and Order Under 11 U.S.C. § 1129 and Rule 3020 of the Federal Rules of Bankruptcy Procedure Confirming the Debtors' Joint Plan of Reorganization of Startec Global Communications Corporation et al., which order was signed by the United States Bankruptcy Court for the District of Maryland, Greenbelt Division, in Cases Number 01-25009, 01-25010 and 01-25-013 (Jointly Administered under Case No. 01-25013) on \_\_\_\_\_, 2002 and entered on the docket of the Bankruptcy Court on \_\_\_\_\_, 2002.

4. **Term.** The right to exercise this Warrant shall expire on the later of (a) five (5) years after the date hereof, and (b) six (6) months after both the Senior Note and the Junior Note issued to NTFC Capital Corporation pursuant to the Plan have been repaid in full.

5. **Exercise Price.** The exercise price of this Warrant (the *Exercise Price*) shall be Zero Dollars and Forty cents (40¢) per share, subject to adjustment from time-to-time as set out below.

## 6. Adjustments to Warrant Number and Exercise Price.

(a) **Stock Split or Dividend.** In case the shares of Common Stock at any time outstanding shall be subdivided into a greater or combined into a lesser number of shares of Common Stock, by stock-split, reverse split or otherwise, or in case shares of Common Stock shall be issued as a stock dividend, the Warrant Number shall be increased or decreased, as applicable, to an amount which shall bear the same relation to the Warrant Number in effect immediately prior to such subdivision, combination or stock dividend as the total number of shares of Common Stock issued and outstanding immediately after such subdivision, combination or stock dividend shall bear to the total number of shares of Common Stock issued and outstanding immediately prior to such subdivision, combination or stock dividend; likewise, in case of such a subdivision, combination or stock dividend, the Exercise Price shall correspondingly be increased or decreased, as applicable, to the price which shall bear the same relation to the Exercise Price in effect immediately prior to such subdivision, combination or stock dividend as the total number of shares of Common Stock issued and outstanding immediately prior to such subdivision, combination or stock dividend shall bear to the total number of shares of Common Stock issued and outstanding immediately after such subdivision, combination or stock dividend; an adjustment pursuant to this subparagraph shall become effective immediately after the effective date of such subdivision, combination or stock dividend, retroactive to the record date (if any) for such subdivision, combination or stock dividend.

(b) **Dilutive Issuances.** If the Company, at any time or from time to time after the date of this Warrant, shall issue, sell or grant to Allied Capital Corporation, or any affiliate (as defined in Rule 405 promulgated pursuant to the Securities Act of 1933) thereof, shares of Common Stock other than as a stock dividend on, or upon the subdivision or combination of, previously outstanding shares of Common Stock, at a price per share that is less than the Exercise Price on the date of such issuance, sale or grant, then the Exercise Price shall be reduced as of the date of the relevant issuance, sale or grant to a price determined in accordance with the following formula:

$$N = O [(AO+C)/BO]$$

wherein

N = the Exercise Price to be in effect immediately after the subject issuance, sale or grant;

O = the Exercise Price as in effect immediately prior to such issuance, sale or grant;

A = the number of shares of Common Stock issued and outstanding immediately before such issuance, sale or grant;

B = the number of shares of Common Stock issued and outstanding immediately after such issuance, sale or grant; and

C = the net consideration received for such issuance, sale or grant.

(c) **Increase in Warrant Number.** Whenever the Exercise Price is reduced according to the formula set out above, the Warrant Number shall increase to equal the quotient obtained by dividing the product of the original Exercise Price times the original Warrant Number, as dividend, by the reduced Exercise Price as divisor.

(d) **Merger.** In case of any capital reorganization, or any reclassification of the Common Stock of the Company, or in case of any consolidation of the Company with or the merger of the Company into any other entity (other than a consolidation or merger in which the Company is the surviving entity), this Warrant shall after such reorganization, reclassification, consolidation or merger be exercisable upon the terms and conditions specified herein, for the number of shares of stock or other securities or property of the Company, or of the other entity resulting from such consolidation or surviving such merger (as the case may be), which the holder of this Warrant would have been entitled to receive, under the terms of such reorganization, reclassification, consolidation or merger, if this Warrant had been exercised in full prior to such reorganization, reclassification, consolidation or merger. In any such case, if necessary, the provision set forth in this Warrant with respect to the rights and interests thereafter of the Holder shall be appropriately adjusted so as to be applicable, as nearly as may reasonably be, to any shares of stock or other securities or property thereafter deliverable on the exercise of this Warrant. The subdivision or combination of shares of Common Stock at any time outstanding into a greater or lesser number of shares of Common Stock shall not be deemed to be a reclassification of the Common Stock of the Company for the purposes of this subparagraph. The Company shall not effect any such consolidation or merger unless, prior to or simultaneously with the consummation thereof, the surviving entity (if other than the Company) resulting from such consolidation or merger shall assume, by written agreement executed and delivered to the Company, the obligation to deliver to the Holder such shares of stock, securities or assets to which in accordance with the foregoing provisions, such Holder may be entitled, as well as any other obligations arising under this Warrant.

(e) **Adjustments to Numbers of Other Securities.** If as a result of any provision of this paragraph 6 the Holder shall become entitled to acquire any securities of the Company other than or in addition to Common Stock, the number or amount of such other securities to which the Holder is entitled shall be subject to adjustment from time to time in a manner and on terms as nearly equivalent as practicable to the provisions applicable to the Warrant Number, and the provisions of this paragraph with respect thereto shall apply as nearly as may be practicable to such other securities.

(f) **De Minimis.** Anything in this paragraph to the contrary notwithstanding, no adjustment shall be made hereunder in any case where the increase in the Warrant Number would be less than one (1) share of Common Stock; but in such case any adjustment that would otherwise be made shall be delayed and the adjustment shall be made only after one or more subsequent events which, together with any adjustment so delayed, shall entitle Holder to receive at least one (1) whole additional share of such stock.

7. **Covenants As To Par Value, Authority, Preemptive Rights and Charges.** If at any time the per share exercise price of this Warrant shall be less than the par value of one share of Common Stock, the Company shall take such action as shall be necessary to reduce such par value to an amount less than the per share exercise price of this Warrant. The Company shall

take such action as shall be necessary to maintain the authority to issue validly the appropriate number of shares of Common Stock upon exercise of this Warrant according to the terms herein, and shall cause such shares, upon payment of the Exercise Price, to be fully paid, non-assessable, free of preemptive rights and free from all taxes, liens, security interests and charges with respect to the issuance thereof.

#### **8. Required Notices.**

(a) **Notice of Adjustments.** Whenever the Warrant Number and Exercise Price shall change pursuant to the terms of paragraph 6 hereof, the Company shall promptly notify the Holder in writing of such change and deliver to Holder a statement setting forth the Warrant Number and Exercise Price after such adjustment(s), and a brief statement of the facts requiring such adjustment(s) and the computation by which such adjustment(s) was made.

(b) **Notice of Significant Events.** In case the Company shall propose to (1) pay any dividend or make any other distribution to the holders of its capital stock, (2) offer to the holders of its capital stock rights to subscribe for or to purchase shares of Common Stock or shares of any other class of securities, rights or options, (3) effect any reclassification of its capital stock, (4) effect any reorganization, or (5) effect any Significant Corporate Event, then, in each such case, the Company shall give to the holder a notice of such proposed action, which shall specify the date on which a record is to be taken for the purposes of such dividend or distribution, or the date on which such reclassification, reorganization, or Significant Corporate Event is to take place and the date of participation therein by the holders of capital stock, if any such date is to be fixed and shall also set forth such facts with respect thereto as shall be reasonably necessary to indicate the effect of such action on the capital stock, if any, and the number and kind of any other shares of capital stock which will comprise the Warrant Shares, and the Exercise Price, after giving effect to any adjustment, if any, which will be required by Section 6 as a result of such action, if such adjustments are capable of determination prior to the effective date of dividend, distribution, reclassification, reorganization or Significant Corporate Event. Such notice shall be so given in the case of any action covered by clause (1) or (2) above at least 20 days prior to the record date for determining holders of the capital stock for purposes of such action, and in the case of any other such action, at least 30 days prior to the date of the taking of such proposed action or the date of participation therein by the holders of capital stock, whichever shall be the earlier.

(c) **Notice of Expiration.** The Company shall provide written notice to the Holder at least 60, but not more than 90, days prior to the termination of the Warrant.

#### **9. Exercise Procedures.**

(a) **Unconditional Subscription.** This Warrant may be exercised in whole or in part by presenting it and tendering the aggregate Exercise Price in legal tender or by bank's, cashier's or certified check to the Company at its address specified in the Investment Agreement, along with a written subscription notice substantially in the form of Exhibit 9.00 hereof. In such case, the date on which this Warrant is thus presented, accompanied by tender or payment as hereinbefore or hereinafter provided, shall be referred to herein as the *Exercise Date*. The Company shall forthwith at its expense (including the payment of issue taxes), issue and deliver the proper number of shares of Common Stock, and such shares shall be deemed validly issued

for all purposes as of the opening of business on the Exercise Date, regardless of any delay in the actual issuance.

(b) **Conditional Exercise.** This Warrant may also be exercised in whole or in part conditionally in contemplation of the future consummation of one or more transactions, by presenting it and tendering the aggregate Exercise Price in the manner specified in subparagraph (a) above, along with a notice clearly stating the conditional nature of the exercise, specifying the conditions precedent to the exercise in reasonable detail and the date after which the exercise shall be deemed withdrawn if such conditions remain unsatisfied, and otherwise containing the information called for in **Exhibit 9.00**. Upon such presentment, tender and notice, if the specified conditions are satisfied within the specified period without prior revocation of the exercise by Holder, the Company shall forthwith issue and deliver the proper number of shares of Common Stock in the manner described above. In such case, the date on which the last remaining condition was met shall be referred to herein as the Exercise Date, and such shares shall be deemed validly issued for all purposes as of the opening of business on such Exercise Date, regardless of any delay in the actual issuance. If, on the other hand, after any such presentment, tender and notice, any condition is unsatisfied on the specified date, or if the Holder revokes such exercise in writing prior to the satisfaction of all conditions, the Company shall forthwith return this Warrant and the Exercise Price to the Holder, and this Warrant shall be deemed not to have been exercised.

10. **Transfer; Restrictions on Transfer.** This Warrant shall be registered on the books of the Company which shall be kept at its principal office for that purpose, and shall be transferable in whole or in part but only on such books by the Holder in person or by duly authorized attorney with written notice substantially in the form of **Exhibit 10.00** hereto, only in compliance with the preceding paragraph, and only in compliance with certain transfer restrictions set out in the Agreement. The Company may issue appropriate stop orders to its transfer agent to prevent a transfer in violation of such restrictions or the preceding paragraph.

11. **Closing of Books.** The Company shall not close its transfer books against the transfer of this Warrant or any Common Stock or other securities issuable upon the exercise of this Warrant in any manner which interferes with the exercise of this Warrant.

12. **Replacement of Warrant.** At the request of the Holder and on production of evidence reasonably satisfactory to the Company of the loss, theft, destruction or mutilation of this Warrant and (in the case of loss, theft, or destruction) if required by the Company, upon delivery of an indemnity agreement with surety in such reasonable amount as the Company may determine thereof, the Company at its expense will issue in lieu thereof a new Warrant of like tenor.

13. **Investment Covenant.** The Holder by its acceptance hereof covenants that this Warrant is, and any stock issued hereunder will be, acquired for investment purposes, and that the Holder will not distribute the same in violation of any state or federal law or regulation.

14. **Form of Notice.** Any notice or other communication required by this Warrant to be given to the Holder shall be provided as follows:

**15. Waiver of Jury Trial.** THE COMPANY WAIVES ALL RIGHT TO TRIAL BY JURY OF ALL CLAIMS, DEFENSES, COUNTERCLAIMS AND SUITS OF ANY KIND DIRECTLY OR INDIRECTLY ARISING FROM OR RELATING TO THIS WARRANT OR THE DEALINGS OF THE PARTIES IN RESPECT HERETO. THE COMPANY ACKNOWLEDGES AND AGREES THAT THIS PROVISION IS A MATERIAL TERM OF THIS WARRANT AND THAT THE HOLDER WOULD NOT EXTEND ANY FUNDS UNDER THE LOAN DOCUMENTS IF THIS WAIVER OF JURY TRIAL WERE NOT A PART OF THIS WARRANT. THE COMPANY ACKNOWLEDGES THAT THIS IS A WAIVER OF A LEGAL RIGHT AND THAT IT MAKES THIS WAIVER VOLUNTARILY AND KNOWINGLY AFTER CONSULTATION WITH, OR THE OPPORTUNITY TO CONSULT WITH, COUNSEL OF ITS CHOICE. THE COMPANY AGREES THAT ALL SUCH CLAIMS, DEFENSES, COUNTERCLAIMS AND SUITS SHALL BE TRIED BEFORE A JUDGE OF A COURT OF COMPETENT JURISDICTION, WITHOUT A JURY.

IN WITNESS WHEREOF, the Company has caused this Warrant to be signed on its behalf by its undersigned officer, and its corporate seal to be affixed hereto, as of the date first above written.

SEAL:

**Startec Global Communications Corporation**

Attest: \_\_\_\_\_,  
\_\_\_\_\_, Secretary

By: \_\_\_\_\_  
Ram Mukunda, President

Exhibit 9.00

IRREVOCABLE SUBSCRIPTION

To: Startec Global Communications Corporation

Gentlemen:

The undersigned hereby elects to exercise its right under the attached Warrant by purchasing \_\_\_\_\_ shares of the Common Stock of your company, and hereby irrevocably subscribes to such issue. The certificates for such shares shall be issued in the name of

\_\_\_\_\_  
(Name)

\_\_\_\_\_  
(Address)

\_\_\_\_\_  
(Taxpayer Number)

and deliver to \_\_\_\_\_

(Name)

\_\_\_\_\_  
(Address)

The exercise price of \$ \_\_\_\_\_ is enclosed.

Date: \_\_\_\_\_

Signed: \_\_\_\_\_ (Name of Holder, Please Print)

\_\_\_\_\_  
(Address)

\_\_\_\_\_  
(Signature)

Exhibit 10.00

ASSIGNMENT

FOR VALUE RECEIVED, the undersigned hereby assigns to

\_\_\_\_\_

(Name)

\_\_\_\_\_

(Address)

\_\_\_\_\_

\_\_\_\_\_ the attached Warrant together with all right, title and interest therein, and does hereby irrevocably appoint \_\_\_\_\_ attorney to transfer said Warrant on the books of **Startec Global Communications Corporation**, with full power of substitution in the premises.

Done this \_\_\_\_ day of \_\_\_\_\_, 20\_\_.

Signed: \_\_\_\_\_

By: \_\_\_\_\_

Its: \_\_\_\_\_



# **EXHIBIT C**

## **Form of Holdings Certificate of Incorporation**

AMENDED AND RESTATED  
CERTIFICATE OF INCORPORATION  
OF  
STARTEC GLOBAL COMMUNICATIONS CORPORATION<sup>3</sup>

The undersigned Corporation hereby certifies as follows:

1. The name of the corporation is Startec Global Communications Corporation (the "Corporation"). The date of filing of its original certificate of incorporation with the Secretary of State was April 21, 1998 under the name "STGC Holding Corporation."

2. This Amended and Restated Certificate of Incorporation amends, restates and integrates the provisions of the Certificate of Incorporation of the Corporation as currently in effect. Pursuant to the authority of Section 303 of the General Corporation Law of the State of Delaware (the "DGCL"), the provisions contained in this Amended and Restated Certificate of Incorporation are contained in and authorized by the Debtors' Joint Plan of Reorganization of Startec Global Communications Corporation et al (the "Plan") Under Chapter 11 Of The Bankruptcy Code, dated as of \_\_\_\_\_, 2002, as modified and confirmed by the Findings of Fact, Conclusions of Law and Order Under 11 U.S.C. § 1129 and Rule 3020 of the Federal Rules of Bankruptcy Procedure Confirming the Debtors' Joint Plan of Reorganization of Startec Global Communications Corporation et al (the "Order"), which Order was signed by the United States Bankruptcy Court for the District of Maryland, Greenbelt Division, (the "Court") in Cases Number 01-25009, 01-25010 and 01-25-013 (Jointly Administered under Case No. 01-25013) on \_\_\_\_\_, 2002 and entered on the docket of the Court on \_\_\_\_\_, 2002. The Court has jurisdiction of the proceedings for the reorganization of the Corporation under Chapter 11 of the United States Bankruptcy Code, 11 U.S.C. § 101 et. seq.

3. The text of the Certificate of Incorporation as currently in effect is hereby amended and restated to read as set forth herein in full:

\_\_\_\_\_

FIRST. The name of the corporation is Startec Global Communications Corporation (hereinafter referred to as the "Corporation").

<sup>3</sup> To be modified as appropriate where Reorganized Holdings is a newly-formed corporation pursuant to the Alternative Plan.

SECOND. The address of the Corporation's registered office in the State of Delaware is 2711 Centerville Road, Suite 400 in the City of Wilmington, County of New Castle, Delaware 19805. The name of its registered agent at such address is Corporation Service Company.

THIRD. The purpose of the Corporation is to engage in any lawful act or activity for which corporations may be organized under the DGCL.

FOURTH.

(a) The total number of shares of capital stock which the Corporation is authorized to issue is Fifty Million, Six Thousand Three Hundred (50,006,300) shares, consisting of Fifty Million (50,000,000) shares of common stock, par value \$0.001 per share ("Common Stock"), and Six Thousand Three Hundred (6,300) shares of preferred stock, par value \$0.001 per share ("Preferred Stock").

(b) COMMON STOCK

(1) Voting Rights. Subject to the voting rights of the holders of Preferred Stock, the holders of Common Stock shall be entitled to one vote per share on all matters to be voted on by the stockholders of the Corporation.

(2) Dividends and Distributions. Dividends may be declared and paid on the Common Stock from funds lawfully available therefor as, if and when determined by the Board of Directors in accordance with the DGCL, provided however, that dividends and distributions may not be declared or paid on any Common Stock until the Preferred Stock has been redeemed in full and the redemption price therefor paid as contemplated in Section (C)(5) below of this Article Fourth. For purposes of this Article Fourth, unless the context requires otherwise, the term "distribution" shall include, without limitation, the transfer of cash or property without consideration, whether by way of dividend or otherwise, payable other than in Common Stock, or the purchase or redemption of shares of capital stock of the Corporation for cash or property, including any such transfer, purchase or redemption by a subsidiary of the Corporation.

(3) Liquidation. Upon any liquidation (voluntary or otherwise), dissolution or winding up of the Corporation, holders of shares of Common Stock will be entitled to receive all assets of the Corporation available for distribution to its stockholders, subject to any preferential rights of any then outstanding Preferred Stock.

(c) PREFERRED STOCK

(1) Voting Rights. Except as provided below, the Preferred Stock shall vote together with the Common Stock as a single class on all actions to be voted on or approved by the stockholders of the Corporation. The holders of Preferred Stock shall be entitled to one vote per share. The affirmative vote of the majority of the

holders of the outstanding Preferred Stock, voting as a separate class, shall be necessary for effecting or validating the following actions:

a. any amendment, alteration, or repeal of any provision of the Certificate of Incorporation of the Corporation that authorizes or creates any additional class of capital stock or that alters or changes the voting powers, preferences, or other special rights or privileges, or restrictions of the Preferred Stock;

b. any reclassification of any outstanding securities of the Corporation;

c. merger or consolidation with or into any corporation if such merger or consolidation would result in the stockholders of the Corporation holding (by virtue of securities issued as consideration in such transaction or otherwise) less than a majority of the voting power of the surviving corporation immediately after such merger or consolidation;

d. sale or other disposition of all or substantially all the Corporation's assets in a single transaction or series of related transactions;

e. liquidation or dissolution of the Corporation; and

g. waiver of any term of the Preferred Stock.

(2) Dividends and Distributions. The holders of Preferred Stock shall not be entitled to receive dividends on account of the Preferred Stock.

(3) Liquidation, Dissolution or Winding Up; Liquidation Preference. Upon any liquidation (voluntary or otherwise), dissolution or winding up of the Corporation, the holders of shares of Preferred Stock shall be entitled to receive, before any distribution or payment on account of any other class of capital stock of the Corporation, from any source of funds legally available therefor, the sum of One Thousand Dollars (\$1,000.00) for each share of Preferred Stock then outstanding (the "Liquidation Preference"). If upon such liquidation, dissolution, or winding up of the Corporation the assets to be distributed among the holders of Preferred Stock shall be insufficient to permit payment to the holders of Preferred Stock of the full Liquidation Preference, then the entire assets of the Corporation to be so distributed with respect to the Preferred Stock shall be distributed ratably among the holders of Preferred Stock in proportion to the full preferential amount payable in respect of the Preferred Stock. Written notice of such liquidation, dissolution, or winding up, stating a payment date, shall be delivered in person, mailed by certified or registered mail, return receipt requested, or sent by telecopier or telex, not less than 20 business days prior to the payment date stated therein, to the holders of record of Preferred

Stock, such notice to be addressed to each such holder at its address as shown by the records of the Corporation. The consolidation or merger of the Corporation into or with any other entity or entities which results in the exchange of outstanding shares of the Corporation for securities or other consideration issued or paid or caused to be issued or paid by any such entity or affiliate thereof (other than a merger to reincorporate the Corporation in a different jurisdiction), the sale, lease, abandonment, transfer or other disposition by the Corporation of all or substantially all its assets, and any acquisition by any person or entity or group of related persons or entities by means of a consolidation, corporate reorganization, merger or other transaction or series of related transactions, of more than 50% of the outstanding voting power of the Corporation shall without limitation be deemed to be in each such case a liquidation, dissolution, or winding up of the Corporation within the meaning of the provisions of this Article Fourth. Upon the payment of the Liquidation Preference, the holders of such shares shall have no further rights to participate in the profits or distributions of the Corporation. No distribution shall be made to the holders of shares of stock ranking junior (either as to dividends or upon liquidation, dissolution or winding up) to the Preferred Stock, unless, prior thereto, the Liquidation Preference is paid in full.

(4) Redemption. The Corporation may redeem the shares of Preferred Stock from time to time, in whole or in part, at a redemption price equal to the Liquidation Preference, payable in immediately available funds. Notice of redemption shall be mailed to each holder of shares of Preferred Stock to be redeemed not less than 30 nor more than 60 days prior to the redemption date. If less than all of the outstanding shares of Preferred Stock are to be redeemed, the Corporation will select the shares to be redeemed by lot.

(5) Ranking. The Preferred Stock shall rank senior to all other series of the Corporation's preferred stock which may be created in the future, as well as the Corporation's Common Stock, as to dividends and the distribution of assets.

(d) All shares of the Corporation's common stock, par value one cent (\$0.01) per share, and any other shares of any other class or series of common or preferred stock of the Corporation, in each case issued and outstanding immediately prior to the filing of this Amended and Restated Certificate of Incorporation, shall be cancelled upon the filing of this Amended and Restated Certificate of Incorporation and without further action by the Corporation or the holders thereof. In accordance with the Plan and the Order, the holders of such shares of capital stock shall not be entitled to any consideration therefor.

#### FIFTH.

(a) The affairs of the Corporation shall be managed and conducted by a Board of Directors. The number of Directors of the Corporation shall be as from time to time fixed by, or in the manner provided in, the Bylaws of the Corporation; provided, however, that in no event shall the number of Directors be less than three (3). In the absence of a determination of such number by the Board of Directors, the number of Directors of the Corporation shall be seven (7).

The Directors shall be elected at the annual meeting of stockholders in accordance with the provisions of the Bylaws of the Corporation, and the election of Directors need not be by written ballot except as and to the extent provided for therein. A majority of the Directors, or, if there is an even number of Directors, one-half of the Directors, shall constitute a quorum for the transaction of business and the Board of Directors shall act in all matters by majority vote, except that any vacancy on the Board of Directors, whether created by an increase in the number of directors or otherwise, may be filled by a majority of Directors then in office, even if less than a quorum, or by a sole remaining Director.

(b) Any Director, or the entire Board of Directors, may be removed from office with or without cause but only by the affirmative vote of a majority of the votes entitled to be cast by the holders of all outstanding shares of each of the Common Stock and Preferred Stock, voting as a single class. Any Director elected or appointed to fill a vacancy shall hold office until the next election at the annual meeting of stockholders, and until his or her successor has been duly elected and qualified or until his or her earlier resignation or removal.

SIXTH. The Board of Directors of the Corporation is expressly authorized to adopt, amend or repeal By-laws of the Corporation. The holders of the Common Stock and the Preferred Stock, voting as a single class, shall, to the extent such power is at the time conferred on them by applicable law, also have the power to make, alter, amend or repeal the By-laws of the Corporation by vote of a majority of the votes entitled to be cast by the holders of all outstanding shares of each of the Common Stock and the Preferred Stock, voting as a single class.

#### SEVENTH.

(a) The personal liability of the directors of the Corporation is hereby eliminated to the fullest extent permitted by Section 102(b)(7) of the DGCL, as the same may be amended or supplemented.

(b) The Corporation shall, to the full extent permitted by Section 145 of the DGCL, as amended from time to time, indemnify all persons whom it may indemnify pursuant thereto. The indemnification and advancement of expenses provided by, or granted pursuant to, this Article SEVENTH shall not be deemed exclusive of any other rights to which those seeking indemnification or advancement may be entitled under the Bylaws or any agreement, action of shareholders or disinterested directors or otherwise, both as to action in their official capacity and as to action in another capacity while holding such office of the Corporation, shall continue as to a person who has ceased to be a director or officer of the Corporation, and shall inure to the benefit of the heirs, executors and administrators of such a person.

(c) No amendment, modification or repeal of this Article SEVENTH shall adversely affect any right or protection of a director or officer of the Corporation under or pursuant to this Article SEVENTH that exists at the time of such amendment, modification or repeal. This Article SEVENTH may not be amended, modified or repealed except by the affirmative vote of not less than two-thirds (2/3) of the votes entitled to be cast by the holders of

all outstanding shares of each of the Common Stock and the Preferred Stock, voting as a single class.

EIGHTH. To the extent required by Section 1123(a)(6) of Title 11 of the United States Code ("Bankruptcy Code"), the Corporation shall not be authorized to issue non-voting capital stock; provided, however, that this Article EIGHTH (a) will have no further force and effect beyond that required under Section 1123 of the Bankruptcy Code, (b) will have only such force and effect, if any, for so long as such Section is in effect and applicable to the Corporation, and (c) in all events may be deemed void or eliminated in accordance with applicable law as from time to time in effect.

NINTH. The Corporation expressly elects not to be governed by Section 203 of the DGCL.

IN WITNESS WHEREOF, this Amended and Restated Certificate of Incorporation has been executed as of the \_\_\_\_th day of \_\_\_\_\_, 2002 on behalf of the Corporation by Ram Mukunda, its President and Chief Executive Officer, thereby acknowledging under penalties of perjury that the foregoing Amended and Restated Certificate of Incorporation is the act and deed of the Corporation and that the facts stated therein are true.

Startec Global Communications Corporation

By:

\_\_\_\_\_  
Ram Mukunda, President and Chief Executive  
Officer



# **EXHIBIT D**

## **Terms of Senior Executive Employment Agreements**

Employer:	<ul style="list-style-type: none"> <li>Startec Global Operating Company ("Company").</li> </ul>
Executive:	<ul style="list-style-type: none"> <li>Ram Mukunda ("Employee").</li> </ul>
Position:	<ul style="list-style-type: none"> <li>President, Chief Executive Officer and Treasurer.</li> </ul>
Term:	<ul style="list-style-type: none"> <li>3 years with annual automatic extensions (90 days written notice of non-renewal by either party).</li> </ul>
Duties:	<ul style="list-style-type: none"> <li>Serve as principal executive officer of Company and perform duties and have powers and authority as determined by Board of Directors.</li> </ul>
Base Salary:	<ul style="list-style-type: none"> <li>\$375,000 annually, payable during Term consistent with Company's normal payroll periods.</li> </ul>
Incentives:	<ul style="list-style-type: none"> <li>Up to \$250,000 annually contingent upon Company meeting or exceeding business performance targets.</li> <li>Participation in Startec Global Communications Corporation's employee incentive stock option plan.</li> </ul>
Other Provisions:	<ul style="list-style-type: none"> <li>In the event that Company terminates Employee for cause or Employee terminates his employment with Company without good reason, Employee shall pay liquidated damages equal to the product of (y) \$1,000,000 and (z) a fraction, the numerator of which is the number of days remaining during such two-year period and the denominator of which is 730, if such termination occurs before the second anniversary.</li> </ul>

Employer:	<ul style="list-style-type: none"> <li>Startec Global Operating Company ("Company").</li> </ul>
Executive:	<ul style="list-style-type: none"> <li>Prabhav Maniyar ("Employee").</li> </ul>
Position:	<ul style="list-style-type: none"> <li>Chief Financial Officer.</li> </ul>
Term:	<ul style="list-style-type: none"> <li>3 years with annual automatic extensions (90 days written notice of non-renewal by either party).</li> </ul>
Duties:	<ul style="list-style-type: none"> <li>Serve as executive officer of Company and perform duties and have powers and authority as determined by Board of Directors.</li> </ul>
Base Salary:	<ul style="list-style-type: none"> <li>\$275,000 annually, payable during Term consistent with Company's normal payroll periods.</li> </ul>
Incentives:	<ul style="list-style-type: none"> <li>Up to \$125,000 annually contingent upon Company meeting or exceeding business performance targets.</li> <li>Participation in Startec Global Communications Corporation's employee incentive stock option plan.</li> </ul>

# EXHIBIT E

## Schedule of Assumed Contracts

CONTRACT/LEASE TO BE ASSUMED	CURE AMOUNT
The Garland Center 1200 West Seventh Street Sublease between Startec Global Communications Corporation and Wells Fargo Bank, N.A., dated September 1, 1998.	\$0.00
PSINET Transaction Solutions Card*Tel Service Agreement between PSINET Transaction Solutions ("TNSI") and Startec Global Operating Company, dated January 19, 2001.	\$0.00
Service Agreement between Startec Global Communications Corporation and L&E Meridian, dated April 1, 2000.	\$0.00
International Telecommunications Service Agreement between Companhia Santomense de Telecomunicacoes, S.A. and Startec Incorporated (now known as Startec Global Operating Company), dated November 15, 1993	\$0.00
International Telecommunications Services Carrier Operating Agreement between Startec Global Communications Corporation and Marconi Portugal, dated January 21, 1998.	\$0.00
Master Service Agreement between Broadwing Communications Services Inc. d/b/a/ IXC Communications Services, Inc. and Startec Global Communications Corporation, dated June 14, 1999, as amended by Amendment Nos. 1, 2, 3 and 4 to the Master Service Agreement.	\$0.00
Reciprocal Carrier Service Agreement between Startec Global Operating Company and Telstra Inc., dated March 28, 2000.	\$0.00
Reciprocal Carrier Services Agreement between Startec Global Operating Company and Asia Access Telecom Inc., dated June 28, 2000.	\$0.00
Reciprocal Carrier Services Agreement between Startec Global Operating Company and Radiant Telecom, Inc., dated January 28, 2000, and Consent to Transfer and Assignment of Carrier Service Contract, dated August 17, 2001.	\$0.00
Reciprocal Agreement between Startec Global Operating Company and Telecom New Zealand, dated May 7, 2001, as amended by Amendment No. 1, dated January 16, 2002 and Amendment No. 2, dated March 21, 2002, and Letter Agreement between Startec Operating Company and Telecom New Zealand, dated May 7, 2001.	\$0.00
Reciprocal Telecommunications Services Agreement between Startec Global Communications Corporation and Telecom New Zealand UK Limited, dated January 27, 2000.	\$0.00

Confidential International Services Agreement between Startec Global Operating Company and Sancroft Investment Limited, dated July 6, 2001.	\$0.00
Carrier Services Agreement between Startec, Inc. (now known as Startec Global Operating Company), and ACC Long Distance Corp., dated September 26, 1996.	\$0.00
Carrier Service Agreement for International Terminating Traffic between Startec Global Operating Company and Qwest Communications Corporation, dated August 19, 1999.	\$0.00
Carrier Service Agreement between Startec Global Operating Company and Sprint Communications Company L.P., dated August 13, 1999.	\$0.00
International Call Termination Agreement between Startec Global Operating Company and AT&T Corp., dated August 2, 1999.	\$0.00
Carrier Services Agreement between Startec, Inc. (now known as Startec Global Operating Company), and MFS International, Inc., dated July 3, 1996, as amended by Amendment to Carrier Services Agreement between Startec and Worldcom, Inc., successor-in-interest to MFS International, Inc., dated April 7, 1997.	\$0.00
Message Signaling Service Agreement between Startec Global Operating Company and SNET Diversified Group, Inc., dated August 16, 1999.	\$0.00
Agreement between Startec Operating Company and Time Warner Telecom, dated September 14, 1999.	\$0.00
Service Order Agreement between Startec Global Communications Corporation and VoiceLog LLC, dated January 16, 1999	\$0.00

CONTRACT/LEASE TO BE ASSUMED	CURE AMOUNT
<b>Carrier access business relationships with the following companies: *</b>	
New York Access Billing (CLEC)	\$0.00
MCI Worldcom, Inc. (CLEC)	\$0.00
AT&T Corporation (CLEC)	\$0.00
MPower Communications Corp. (CLEC)	\$0.00
McLeodUSA Incorporated (CLEC)	\$0.00
Sage Telecom, Inc. (CLEC)	\$0.00
XO Communications, Inc. (CLEC)	\$0.00

# **EXHIBIT F**

## **Initial Board of Reorganized Holdings**

Ram Mukunda	Chairman, Member
Prabhav Maniyar	Member
Scott Binder (Allied)	Member
Allied Nominee (TBD)	Member
Allied Nominee (TBD)	Member
Allied Nominee (TBD)	Member
NTFC Nominee (TBD)	Member